

**EXAMINING OPPORTUNITIES AND  
CHALLENGES IN THE FINANCIAL  
TECHNOLOGY (“FINTECH”) MARKETPLACE**

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**HEARING**  
BEFORE THE  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
AND CONSUMER CREDIT  
OF THE  
COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED FIFTEENTH CONGRESS  
SECOND SESSION

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## EXAMINING OPPORTUNITIES AND CHALLENGES IN THE FINANCIAL TECHNOLOGY (“FINTECH”) MARKETPLACE

Tuesday, January 30, 2018

U.S. HOUSE OF REPRESENTATIVES,  
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS  
AND CONSUMER CREDIT,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Blaine Luetkemeyer [chairman of the subcommittee] presiding.

Present: Representatives Luetkemeyer, Rothfus, Royce, Lucas, Posey, Ross, Pittenger, Barr, Tipton, Williams, Trott, Loudermilk, Kustoff, Tenney, Clay, Maloney, Meeks, Scott, Green, and Heck.

Also present: Representatives Hensarling, Hollingsworth, Emmer, and Cleaver.

Chairman LUETKEMEYER. The committee will come to order. Without objection, the Chair is authorized to require recess of the committee at any time. This hearing is entitled, “Examining Opportunities and Challenges in the Financial Technology, or Fintech, Marketplace.”

Before we begin, I would like to thank the witnesses for appearing today, I appreciate your participation and look forward to the discussion. I now recognize myself for 5 minutes for the purposes of an opening statement.

From all the electronic payment in use, through blockchain, and crypto-currencies, advances in technologies are changing the way financial markets operate and the way that consumers access credit. Use of these new technologies has proven to spur innovation that aids in the delivery of services and products to consumers and small businesses. These advancements come at a time when bank lending to borrowers with less than pristine credit, small businesses, and startups seems to have stalled.

According to a recent study by Deloitte, marketplace lenders, for instance, accounted for loan originations worth almost \$40 billion over the last decade. Today, many online lenders have a technology to offer consumer and small business loans with better terms and conditions.

An increasing role for fintech also shows the financial needs of Americans have changed. The rise of online banking and mobile payment technologies have revolutionized the way Americans interact with institutions and make financial decisions.

While we should always advocate for innovation that helps the American people and the economy, we must also understand the implications this type of technical revolution can have on consumers and financial institutions.

So my colleagues on this subcommittee have raised questions over both potential positives and negatives these types of lenders may have on underserved borrowers and communities. These are conversations that need to take place so we can have a holistic view of this diverse and growing marketplace.

It is also important to spend time understanding regulatory regimes surrounding fintech, predominantly regulated by the States. Questions have recently been raised as to whether or not Federal laws that apply to similar products and companies, should apply to fintech.

At the Federal level, the previous Comptroller of the Currency, championed an optional Federal charter for fintech companies, an idea that has been debated in Congress for a number of years. The Trump Treasury Department has also opined on ways in which to support safe online lending platforms.

This subcommittee will continue to deliberate measures surrounding fintech that will promote freer and fairer lending to more American families and businesses.

So the bills, including a bill introduced by the gentleman from Indiana, Mr. Hollingsworth, will provide certainty in the marketplace and encourage community banks to partner with fintech companies to better serve their customers.

As we examine these complex issues, we must be careful not to unnecessarily stifle access to capital. We should aim to foster a better understanding of the many facets of fintech and create an environment that fosters responsible innovation without jeopardizing consumer protections or creating an uneven playing field.

The bottom line is that this is a universe that seems to evolve on a nearly daily basis. It is my intention to hold a number of hearings on fintech. I am confident that today's conversation will be a great start, and I will again thank our witnesses for their time.

The Chair now recognizes the gentleman from Missouri, Mr. Clay, Ranking Member of the subcommittee, for 5 minutes for an opening statement.

Mr. CLAY. Thank you, Mr. Chairman, and I will not take the entire 5 minutes, but I appreciate you holding this hearing to examine opportunities and challenges in the fintech marketplace. Thank you to each of the witnesses for shedding light on this subject.

In June 2016, the Obama Administration held a White House fintech Summit to engage with stakeholders about the potential for fintech. Then in January 2017, the Administration compiled its takeaways into a statement of principles as a policy framework for the fintech ecosystem.

The 10 principles encourage stakeholders to; one, think broadly about the financial ecosystem; start with the consumer in mind; promote safe financial inclusion and financial health; recognize and overcome potential technological bias; maximize transparency; strive for interoperability and harmonize technical standards; build in cybersecurity, data security, and privacy protections from the start; increase efficiency and effectiveness in financial infrastruc-

ture; protect financial stability; and continue and strengthen cross-sector engagement.

Under the Trump Administration, the Treasury Department has indicated plans of releasing a paper on non-bank financial institutions, financial technology, and financial innovation as part of their comprehensive financial regulatory review pursuant to Executive Order 13772 from President Trump.

It is unclear when Treasury's fintech paper may be released, so this is a timely and important hearing. Thank you all, again, to each of today's witnesses, and I yield back the balance of my time.

Chairman LUETKEMEYER. The gentleman yields back.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus, Vice Chair of the subcommittee, for 2 minutes to deliver an opening statement.

Mr. Rothfus.

Mr. ROTHFUS. Thank you. Thank you, Mr. Chairman. I want to thank you and the Ranking Member Clay for calling today's hearing on the fintech marketplace. This is an important topic, and it demands the attention of policymakers.

Just as the growth of fintech presents us with regulatory questions and the challenge of dealing with disruptive technological change, it also represents a tremendous opportunity to make more and better financial products available to an even greater number of consumers.

As we look at communities that have lost their local bank or underserved areas trying to get back on their feet, fintech can be a solution. New online lending programs, mobile banking, and other developments can help bring capital back into places that brick and mortar institutions abandoned a long time ago.

I should mention that fintech is an issue in which I have a parochial interest. Western Pennsylvania has become a fintech hub, drawing on the region's high quality workforce and premier educational institutions.

Major western Pennsylvania financial institutions, like PNC and BNY Mellon, have ventured into the fintech space, setting up dedicated facilities to cultivate new ideas. The region is also home to promising incubators, like SteelBridge, as well as independent entrepreneurs who work tirelessly to bring new fintech products to market.

I had the privilege of meeting with many of western Pennsylvania's fintech leaders and learning about the opportunities and challenges they face.

I hope that our work on this committee will help to allow for continued innovation while providing sufficient supervision and consumer protection. I look forward to hearing from today's witnesses how we can take our first steps on this important issue.

With that, Mr. Chairman, I yield back.

Chairman LUETKEMEYER. The gentleman yields back.

With that, let us introduce the panel today. We welcome the testimony of Mr. Nathaniel Hoopes, Executive Director, Marketplace Lending Association; Mr. Brian Knight, Director of the Program on Financial Regulation and Senior Research Fellow at the Mercatus Center, George Mason University; Mr. Brian Peters, Executive Director, Financial Innovation Now; Mr. Andrew Smith, Partner,

Covington and Burlington, Professor Adam Levitin, Professor of Law, Georgetown University Law Center.

Each of you will be recognized for 5 minutes to give an oral presentation or testimony. Without objection, each of your written statements will be made part of the record.

As a tutorial on the lights, some of you may not have been here before, green means go. At the 1-minute mark, a yellow light will come on, hopefully you can wrap it up at that point. Red means stop, and hopefully we can wrap it up very quickly.

With that, Mr. Hoopes, you are recognized for 5 minutes.

#### **STATEMENT OF NATHANIEL HOOPEES**

Mr. HOOPEES. Thank you, Mr. Chairman, Ranking Member Clay, members of the committee for the opportunity to testify here today. I also would like to thank the staff for their hard work.

The Marketplace Lending Association (MLA) formed in 2016. It has grown to 20 member companies. The criteria for membership are that platforms meet a standard of safety responsibility toward consumers and to the marketplace.

MLA members must be transparent with consumers about APR, annualized rates, any penalties or fees in the loans, and not offer any so-called payday or high-cost installment loans to find in numerous places, including the Military Lending Act as loans above 36 percent APR.

In small business lending, MLA member platforms adhere to the Responsible Business Lending Coalition, a group of both for-profit and non-profit entities that came together to create the borrower's bill of rights or to an equivalent standard.

Mr. Chairman, Ranking Member Clay, this industry is effectively serving the broad American middle class, one that remains the engine for economic growth and prosperity today. It is also creating opportunities for investors that previously were reserved only for the wealthiest borrowers or the wealthiest in America.

MLA members can save borrowers as much as \$20,000 in student loan refinancing. They can save members thousands of dollars in refinancing high-cost credit card debt.

They can reach the broad underserved population in America. They can help those underserved populations secure a better financial future for themselves, for their families, and for small businesses.

Today, I would like to talk about opportunities for this committee, and indeed for Congress generally, to take action to support legislation and new chartering opportunities for some financial technology firms that can broadly advance the interests of America's middle class.

So what are marketplace loans? Fintech data tracking firm dv01 advises that more than a million marketplace loans were issued last year; the average loan balance \$14,000, the average APR 14.7 percent. These are far from the short-term, high-rate products that many associated with the earliest days of online lending.

These are also well-regulated loans. These are loans that are overseen by the FDIC (Federal Deposit Insurance Corporation), loans overseen by State consumer protection regulation, and loans that are offered in a transparent way to consumers across America.

Today, there is more than \$1.023 trillion in outstanding credit card debt. That is an enormous debt that borrowers have an opportunity to refinance with marketplace lenders at lower rates.

Small business owners report they are very pleased with having new online options. 95 percent report they would consider taking another loan with another online lender.

So imagine the possibilities if we could update the regulatory framework, one that we use today designed for a 19th and 20th century banking system that didn't envision the Internet to one where startups, small businesses, and innovators can better serve consumers, businesses, students.

To do that, encourage the Congress to move the Protecting Consumers' Access to Credit Act, a bill sponsored by members of this committee that passed earlier in November.

I would also support the committee to look at the IRS Data Modernization Act. That one bill would enable a small business lender to verify a borrower's income in real time, rather than waiting weeks, a time that often in today's economy they don't have, and to serve a small business owner with a better product because they have a better picture of that person's true financial profile.

Finally, this committee should support options for fintech firms to apply for charters. The special purpose national bank charter at the OCC (Office of the Comptroller of the Currency) and the FDIC, ILC charter are both under development. I appreciate the time, and I thank the committee.

[The prepared statement of Mr. Hoopes can be found on page 40 of the appendix.]

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we recognize Mr. Knight for 5 minutes.

#### **STATEMENT OF BRIAN KNIGHT**

Mr. KNIGHT. Thank you, Chairman Luetkemeyer, Ranking Member Clay, and the members and staff of the subcommittee. I am honored to testify today.

Whether it is a mortgage to buy a first home, the ability to quickly and cheaply send money to a loved one, or accessing credit when in need, financial services are vital to the American dream.

Advances provided by financial technology, or fintech, have the potential to provide Americans with better, cheaper, and more inclusive financial services. Unlocking that potential requires modernizing the regulatory environment to encourage innovation and competition while providing Americans with necessarily consumer protection.

Because while financial technology may be able to help people, there is a risk that mis-regulation will inhibit this possibility. So Congress should modernize regulation to foster innovation, competition, and inclusion.

Financial services are seeing a series of potentially significant changes, including the removal of geographic limitations thanks to the Internet and mobile devices, use of new algorithms, and machine learning, the entrance of firms from outside traditional finance, including both startups and well-established companies like Amazon, and the rapid adoption of new services by customers.

Peer-to-peer and mobile payment are now practical. As well as daily payments for workers, removing the need to wait for payday. There are also innovations like cryptocurrencies, which some believe could entirely remake the financial system, along with the capital markets, real estate, and other industries.

While not a panacea, these innovations show real promise. For example, there is evidence that innovative lenders can offer borrowers credit at better rates or extend credit to borrowers who would otherwise have trouble accessing it.

Evidence also indicates that innovative lenders are replacing banks in communities where banks have been forced to leave because it is no longer profitable for them to serve. And that algorithmic underwriting may lead to less discrimination than traditional underwriting.

However, there is also risk. While technology enables legitimate businesses to reach new customers without regard for distance, it also allows fraudsters to find new victims. While cryptocurrencies allow the oppressed to avoid the predations of their government, it can allow those same governments to avoid sanctions.

Done well, initial coin offerings (ICOs) might make our capital markets more efficient. Done poorly, they leave both investors and well-meaning but ignorant companies exposed.

While there are risks, we must remember two things. First, there is no regulatory vacuum. Regulators currently have and are using the power to prohibit and punish violations of the law.

Fintech lenders that partner with banks are subject to regulation by the bank's regulators and the CFPB (Consumer Financial Protection Bureau). And the CFPB, SEC (U.S. Securities and Exchange Commission), FTC (Federal Trade Commission), and CFTC (Commodity Futures Trading Commission) have all brought enforcement actions in fintech-related areas and will continue to do so.

Second, we must remember that traditional finance also presents risk. As such, fintech innovations should not be judged against perfection, but against the status quo. While some regulation is necessary to protect Americans, the current regulatory environment unduly impedes positive innovation in several ways.

In the interest of time, I will limit my discussion to three. First, many non-bank fintech firms are subject to burdensome State-by-State regulation in areas where banks offering comparable products enjoy broad uniformity thanks to Federal law. This makes it difficult, if not impossible, for these innovative firms to compete directly with banks.

The OCC charter previously mentioned is one possible avenue to address this problem, at least for some firms, but it is unclear whether or not it will move forward and whether or not it will be viable if it does. Even if the OCC charter does move forward, it should not be the only option available.

Second, even if firms partner with banks, recent litigation and regulatory actions have called into question the legitimacy of those partnerships. This risks reducing access to those most in need of new options.

Third, the United States lacks a scalable way for companies to safely experiment with new technologies. Countries, including the

United Kingdom, Australia, and Singapore, have pursued a so-called regulatory sandbox to provide firms a way to try new products with a lower regulatory burden while still protecting consumers.

While some regulators at the Federal and State level are working to become more welcoming to innovation, the fragmentation of our regulatory system makes it hard to create a program that provides a truly friendly environment for experimentation.

Congress can help encourage better financial services for all Americans. It can do this by providing certainty to the bank partnership model, a path to regulatory equity that can include both the OCC and the States, and a mechanism for State and Federal regulators to allow innovators to try new ideas while protecting investors.

Doing so will help ensure our financial system is competitive, innovative, and inclusive for the future.

I look forward to our discussion, and thank you for your time.

[The prepared statement of Mr. Knight can be found on page 52 of the appendix.]

Chairman LUETKEMEYER. The gentleman yields back.

Mr. Peters, you are recognized for 5 minutes. Welcome.

#### **STATEMENT OF BRIAN PETERS**

Mr. PETERS. Thank you, Chairman Luetkemeyer, Ranking Member Clay, and members of the committee for the opportunity to testify. My name is Brian Peters, and I am the Executive director of Financial Innovation Now, FIN, an alliance of tech companies working on policies to make financial services more accessible, safe, and affordable.

The members of FIN are Amazon, Apple, Google, Intuit, and PayPal. These companies are at the forefront of America's economic growth. They collectively employ over 700,000 people and spend more on R&D, \$40 billion annually, than any other companies in the United States.

They are innovating many new financial tools, such as digital wallets, secure online payments, personal finance apps, and access to capital for small businesses. Many of these tools work in partnership with traditional financial institutions.

We believe that one of the best opportunities of technology is the potential to improve financial inclusion and increase access. 25 percent of Americans remain unbanked or underbanked, but there is growing evidence that the mobile Internet is helping to reduce some of the traditional barriers to financial services.

The speed of money also matters. In our era of instant messaging it does not make sense that it can still take days for a payment to clear.

For those on a tight budget, like half of Americans living paycheck to paycheck, this delay could cause undue hardship in the form of high cost alternative financial services, sometimes costing 10 percent of income just to access money when it is most needed.

Fortunately, the Federal Reserve is shepherding a commendable industry-led effort to achieve faster payments by 2020. FIN is a part of this effort and supports the Fed's leadership because we

want real-time payment clearing to be a 24/7 reality as soon as possible.

Financial management applications also offer another area of promise. These tools have helped millions of consumers and business to create budgets, set savings goals, avoid fees, and find better offers. It is like having your own personal accountant.

Small businesses also have new options. FIN members already offer a broad set of small business technology tools, including payment processing, payroll, inventory management, sales and data analytics, and shipping logistics, just to name a few, all of which make basic elements of running a business faster and less expensive, both online and on Main Street.

We are now expanding this technology toolbox with the addition of capital. It is our broader integration of these tools that enables small businesses to utilize their own sales and accounting data to qualify for capital quickly and conveniently. Importantly, early research shows that these sources of capital are filling gaps for underserved small businesses.

All of these tools mean more competitive and broader economic growth. These benefits could be enhanced through policies that keep pace with innovation and meet the needs of today's consumers and commerce.

My written testimony contains a number of commonsense policy proposals for the committee's consideration. I will briefly mention several.

No. 1, create an optional national money transmission license. Payment innovators currently are regulated under a fractured regime in nearly every State.

An optional, national license would offer consistent safeguards and it would enhance innovation and consumer access to new payment options evenly across the country.

No. 2, update the Card Act to include oversight of card network rules and their impact on consumer choice and access to payments.

No. 3, restore the valid when made principle. FIN thanks the committee for passing the Protecting Consumers' Access to Credit Act introduced by Congressman McHenry and Congressman Meeks.

No. 4, support the good institutional work of financial regulators to better address technology, such as the OCC's Office of Innovation and the Consumer Financial Protection Bureau's Project Catalyst.

Financial Innovation Now thanks the committee for the opportunity to testify, and we look forward to working with you toward a better financial services future. Thank you.

[The prepared statement of Mr. Peters can be found on page 108 of the appendix.]

Chairman LUTKEMEYER. Thank you, Mr. Peters.

Mr. Smith, and the professor, you guys have a tough bar to go over here in these. I have three guys, and they hit their time right on the dot here.

Mr. Smith, welcome. You are recognized for 5 minutes.

**STATEMENT OF ANDREW SMITH**

Mr. SMITH. Thank you, yes, a hard act to follow. Everyone hit it right on the money. Chairman Luetkemeyer, Ranking Member Clay and members of the subcommittee, thank you for the opportunity to appear before you. My name is Andrew Smith. I am a Partner in the law firm of Covington and Burling and currently serve as the Chairman of the Consumer Financial Services Committee of the American Bar Association.

I am appearing this morning on my own behalf to testify about the opportunities and challenges presented by fintech and the need to amend existing laws to ensure the continued ability of banks to partner with fintech firms to deliver new and innovative products and services to consumers.

The use of fintech to offer credit products to consumers enhances competition and increases consumer access to high-quality credit offered conveniently over the Internet and mobile devices.

But, the electronic marketing, origination, and servicing of credit products is technically demanding. And many banks, particularly community banks, don't have the technical expertise to provide these products safely and efficiently.

Smaller banks also may not have the capital and liquidity to achieve the critical mass needed for a national lending program. Fintech firms, for their part, need banks to access the payment system and to establish a national platform to offer products on a 50-State basis.

In other words, banks and fintech firms need one another, and the relationship between them can pay big dividends for consumers and for the economy.

The FDIC has recognized the importance of permitting banks to partner with fintech firms to offer credit products to consumers and has laid out a robust regime for supervising these relationships, including 12-month examinations cycles, concurrent risk management, and consumer protection examinations, and direct supervision of the fintech firms themselves.

Allowing banks and fintech firms to partner with one another to offer credit to consumers enables consumers to work with a federally supervised lender giving them greater confidence and security and helping to integrate them into the traditional banking system.

All of these benefits, however, are being threatened by a new line of court decisions concluding that, even where a bank made the lending decision, funded the loan, and is the legal lender, the bank may not be the so-called true lender if the bank does not have the quote/unquote "predominant economic interest" in the loan.

Many courts have reviewed the loan agreement to determine that the bank is, indeed, the lender, and that there is no basis to upset the agreed-upon relationship between the lender and the borrower.

Other courts, however, have taken it upon themselves to look through the loan agreement and the legal rights and obligations of the parties to make a subjective determination that the bank is not the true lender. These courts have held that a third-party service provider or even an investor might be the actual lender.

These court decisions have the potential to upset the well-settled commercial expectations of the various participants in the transaction because if the bank is not the true lender, then the Federal

banking laws may not apply, and the underlying loan, or even a whole portfolio of loans, may be considered to be invalid under State lending laws.

This type of uncertainty is unacceptable to participants in financial markets, and if these decisions start to take hold, banks may find it impossible to find firms willing to partner with them on acceptable terms, and we would risk losing all of these demonstrated consumer and economic benefits of partnerships between fintechs and banks.

Although the law, in my judgment, already is crystal clear that if a bank makes a loan, then the bank is the lender, legislation has been introduced that would reiterate and reconfirm this bedrock principle and would make clear that the existence of a service or an economic relationship between a bank and another person doesn't change the fact that the bank made the loan.

This legislation would create greater certainty in commercial relationships and provide the additional clarity and direction to these courts considering true lender challenges. Thank you again for inviting me to testify. I would be happy to answer any questions.

[The prepared statement of Mr. Smith can be found on page 119 of the appendix.]

Chairman LUTKEMEYER. Thank you, Mr. Smith.  
Professor. Welcome. You are recognized for 5 minutes.

#### STATEMENT OF ADAM LEVITIN

Mr. LEVITIN. Thank you. Mr. Chairman Luetkemeyer, Ranking Member Clay, members of the subcommittee, good morning.

My name is Adam Levitin. I am a Professor of law at Georgetown University. Thank you for inviting me to testify here. I am testifying solely as an academic who studies consumer finance. I have no financial interest in any fintech company.

I would like to note that a number of my students from my consumer finance class are here today, and I am glad that they are having the opportunity to witness the legislative process in action.

Chairman LUTKEMEYER. Do they get extra credit for that, professor?

Mr. LEVITIN. I certainly will take it into consideration.

There are a huge range of non-bank financial services companies that fall under the rubric of fintech. Some offer payment services and some offer credit services. Some compete with banks and some partner with banks. Some fintechs provide services that can really help improve Americans' financial lives, as you have heard from the other witnesses.

But other fintechs, particularly in the credit and cryptocurrency areas, engage in predatory and abusive behavior. While it is easy to get caught up in the hype around fintechs, it is important to distinguish among them and take actions to facilitate the good players in the fintech space without also protecting the abusive ones.

My written testimony contains several concrete suggestions for the subcommittee to consider, and I would like to highlight three of them. First, I would urge the subcommittee to consider the creation of a Federal money transmitter license.

It is a Federal felony to transmit money without a license, and the current money transmitter licensing regime is State-based.

This might make sense for small money transmitters operating from a store front or two, but it makes little sense to require companies like Amazon, Apple, or PayPal, that operate national Internet-based payments platforms, to get 50 different money transmitter licenses. A Federal money transmitter license will eliminate duplicative State regimes.

I would, however, also urge that any Federal money transmitter licensing regime be paired with an insurance requirement to protect consumer funds held by transmitters such as balances in PayPal accounts. These balances are currently uninsured, and that is concerning.

Second, the committee should consider steps to encourage greater consumer financial data portability. Banks are often reluctant to enable the sharing of consumer's data with fintechs whom they correctly see as potential competitors.

But this is precisely why such data portability should be encouraged. Consumer banking relationships are sub-optimally sticky. Consumers don't switch financial relationships when they should, and that means consumers end up overpaying for their banking services.

Giving consumers' greater right regarding the portability of data, that their own transactions have generated, would help them improve the competitive landscape of consumer financial services. I would like to relatedly endorse a point that Mr. Peters made about amending the Card Act with regard to card association rules.

Third, I strongly urge the subcommittee not to encourage predatory lending through rent-a-bank schemes. Unfortunately, both H.R. 4439, the Modernizing Credit Opportunities Act, and H.R. 3299, the so-called Madden Fix Bill, do precisely this.

These bills are blank checks for predatory lending. These bills enable banks to launder loans for non-bank lenders by letting the non-bank lenders buy not just the loans from the banks, but also the benefit of Federal preemption of State consumer protection laws.

It is frankly outrageous that Congress would even consider facilitating such an abuse of the banking system. Federal preemption of State law is part of a package that goes with an extensive system of Federal regulation to which fintechs are not fully subject.

Preemption is a personal privilege for banks, and it is really not something they can sell, yet that is exactly what H.R. 4439 and H.R. 3299 do. These bills put preemption of State laws up for sale.

I recognize that H.R. 3299 is presented as a bill to protect so-called marketplace lenders, but it is drafted so broadly that it also shields Internet payday lenders and debt buyers.

Indeed, both bills would actually enable payday lending in roughly half the States that prohibit it outright, and they would effectively void the interest rate and rollover limitations that are imposed by the half of States that do allow payday lending but regulate it. In other words, H.R. 3299 and H.R. 4439 are bills that authorize unrestricted payday lending nationally.

If Congress wants to do that, it should be upfront about what it is doing rather than claiming that it is restoring a legal doctrine or reining in errant court decisions.

There are a lot of ways that fintechs can improve consumers' lives, and we should encourage them when they do that. But the fintech buzz word should not be a license for permitting risky, abusive or fraudulent behavior in the financial system. I look forward to your questions.

[The prepared statement of Mr. Levitin can be found on page 84 of the appendix.]

Chairman LUTKEMEYER. Thank you, Professor.

Would your students please raise their hand? Very good. Well, welcome, and if you need an excuse for the rest of your classes that you are going to skip today, let me know. We can help you out with that.

But again, I thank all the witnesses for their testimony today. We have a little housekeeping issue here right quick.

Without objection, the gentleman from Illinois, Mr. Hultgren, the gentleman from Indiana, Mr. Hollingsworth, the gentleman from Minnesota, Mr. Emmer, the gentleman from Missouri, Mr. Cleaver, are permitted to participate in today's subcommittee hearing.

While not members of the subcommittee, they are all members of the Financial Services Committee. We appreciate their participation today.

This is, as you can see, a very, very interesting and very much needed conversation to have. We have a lot of other members that want to participate today, so we look forward to the discussion. Let me recognize myself for 5 minutes and begin the discussion.

Mr. Knight, you are recognized as the director of Program on Financial Regulation, so can you give me just a little discussion here with regards to fintech is an area where we need to be very careful.

We want to make sure we don't—we want to continue to allow innovation. We want to make sure we keep a level playing field. So how do you thread the needle on regulating too much, not enough, make sure that people are protected yet allow the innovation it takes.

Can you just describe a little bit what you think would be a scenario under which we can keep the playing field level and allow innovation and still protect consumers?

Mr. KNIGHT. Thank you, sir. I will try.

Chairman LUTKEMEYER. It is a big question, I know.

Mr. KNIGHT. It is a challenging question. The important thing that we need to think about is keeping the consumer always in mind first and foremost. There is nothing sacred about any particular type of financial service. It is all about what serves the customer's need.

If something better comes along that displaces payday or banks or marketplace or whatever, and it serves customers' needs better, we should allow that to happen and not shed a tear. So that is the first goal post.

With regards to a level playing field, which is obviously a phrase that gets thrown around a lot, we need to regulate to the risk. To compare and contrast banks with marketplace lenders, banks fund their loans, in part, through federally insured deposits.

Federal insurance of the deposit, the fact that they are using deposits that are given to them by customers with the understanding that the customer can demand it back at any time, that the cus-

tomers is not taking on any risk that their balance will go down, implicates certain rules and regulations and a certain legitimate need for a certain type of consumer protection.

Loans that are funded by investors who know they are putting their money up for risk and are not federally insured present different types of consumer protection risks.

In that case, the concern should be around the investor, not taking on extra contractual risk. By this I mean if I invest money in a loan, I understand I am taking on the risk that the borrower might default.

What I am not taking on is the idea that the lender might fail and sever the connection between me and the borrower. So the borrower, check in hand, willing to pay off his loan, just doesn't know where to send it to, and I am sitting on the other end unable to get funding. Things like backup servicing provisions would be very important in that respect.

With regards to our mindset, one thing we need to think about is the idea of enabling and helping regulators get a better understanding of the pace of innovation because it is ever increasing. Regulators, while well-meaning, often find themselves behind the times a bit.

That is one of the reasons why I commend that we look at the concept of something like a regulatory sandbox, which, as with everything else in this space, there are some definitional issues.

But an environment where regulators can engage with companies in a scalable way, that companies can try new things out with the understanding that they must protect their consumers. If consumers are harmed due to a violation of the law, the company stands ready to make them whole.

Chairman LUETKEMEYER. If I can interject just 1 second, that is an interesting way to go. We need to be looking at this because basically what you are saying is we need to allow pilot projects with safe harbors for the entities to be able to develop a product, and if it works, fine. If it doesn't work, they can move on.

But there needs to be in place a regulatory regime within which they allow that to happen. Is that basically what you are saying?

Mr. KNIGHT. Absolutely, with two other caveats. One, this pilot program should not be a place where only favored firms can get in and obtain major competitive advantage. There are ways we can mitigate against that risk.

Two, the pilot program should not just be necessarily at the Federal level. The States present an excellent venue for this and can serve as, as the cliché goes, laboratories of democracy.

But because of the overlapping and fractured nature of Federal regulation in this space, there is going to have to be some clarification, some forbearance instituted to allow that to be viable.

Chairman LUETKEMEYER. OK. My time is about up. I will yield my time back.

With that, we will go to the other gentleman from Missouri, Mr. Clay. You are recognized for 5 minutes. He is the Ranking Member.

Mr. CLAY. Thank you, Mr. Chairman. Professor Levitin, according to Federal Reserve Board Governor, Lael Brainard, and I quote,

“It is often hard for the consumer to know what is actually happening under the hood of the financial app they are accessing.”

“The app’s websites and terms and conditions of fintech advisors and data aggregators often do not explain how frequently data aggregators will access a consumer’s data or how long they will store that data. If things go wrong, consumers may have limited remedies, and it is not uncommon to see terms and conditions that limit the fintech advisor’s liability to the consumer to \$100,” unquote.

Professor Levitin, do you agree with Governor Brainard’s concern? What can Congress do to address these privacy issues?

Mr. LEVITIN. So I absolutely agree with Ms. Brainard’s concerns. There are a few steps Congress can take to address these issues. First would be, legislation that would restrict the use of binding mandatory arbitration clauses in consumer financial contracts.

Unfortunately, Congress voted to overturn very narrowly, by one vote, to overturn the CFPB’s rulemaking to that effect. But that is something that Congress should revisit.

Second, besides the arbitration limits, Congress should also consider legislation that would restrict stipulated damages clauses in consumer financial contracts. I haven’t thought through the details of what that would look like, but that should be something Congress should consider.

Mr. CLAY. Would any other panelist like to address how we protect consumers’ data as well as the whole hacking of the checking account and credit card? Anyone?

Mr. Peters.

Mr. PETERS. I would be happy to address this. First, Governor Brainard’s comments in the financial technology space generally are very thoughtful and very welcome. She has brought a deep level of insight to this, especially with respect to consumer protection issues.

I represent a number of companies that are obviously innovating in incredible ways. We take the view that many of the apps and the technology that people have in their pocket enable all kinds of consumer disclosure and better awareness because the technology itself is that much more dynamic.

With respect to the issue you alluded to of consumers accessing their financial data, they are doing that because it is their data and because they want to make better sense of their financial lives. They are using technology tools to better manage their finances, to find savings, to better budget.

When we think about that dynamic, we work with financial institutions, and there has actually been a lot of progress made to help address the needs of the shared customer to make sure that we have a more technologically sophisticated and efficient way to enable that application to work.

There is still a lot more work to be done among industry players to get us to that more efficient connection, and we are getting there, but we need more effort.

Mr. CLAY. Yes, but Mr. Peters, don’t you also agree that they are also exchanging data among these different companies so that they can market to these consumers? It may be a hard sell and it may

not be, but don't consumers have—should they have a say in who can look at their data?

Mr. PETERS. I believe they should have sufficient disclosure and there should be transparency about how the technologies they have are operating, yes.

Mr. CLAY. How do we protect those consumers, too? There are also bad actors, too, that access this data or sometimes can access it in there. The protections are not foolproof, so what do we do about that?

Mr. PETERS. Well, our companies, in many ways, are security companies first. We didn't start off developing another product and then add security on to it, so we take security very seriously.

When it comes to this specific issue, there is a way of doing this called open application interfaces which are a secure and a more efficient way for consumers to establish that connection.

The challenge we have in financial services is that there are very many financial institutions, thousands, and what we need to do is work toward a standardization to allow all these financial institutions to use that approach. That is a secure way to it, and it would address many of the concerns you have.

Mr. CLAY. I thank you for your response.

I went over. I yield back.

Chairman LUETKEMEYER. The gentleman's time has expired.

We have to go with the Vice Chair of the committee, Mr. Rothfus, the gentleman from Pennsylvania is recognized for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman.

Mr. Knight, if I can ask you a couple of questions? It might be helpful to take a look at what some other countries are doing in this space. How does the U.S. compare to other major countries in terms of fintech regulation?

Mr. KNIGHT. Well, I will be honest with you, it is a mixed bag. There are certain countries, the United Kingdom being held up as a general leader, who have taken a very concerted effort to become a leader in the space and have been very innovative in their regulation.

Now, some of that advantage is just baked in. Unlike the fragmented system the United States has, the U.K. has, I believe at this point, three financial regulators, and the Financial Conduct Authority (FCA) is their primary consumer protection regulator.

And that allows them to house a lot of innovative products in the FCA, like the sandbox, like Project Innovate, and gives a one-stop shop for companies to check off all the regulatory boxes. The U.K. also doesn't have the federalism that we have.

Other countries like Singapore and Australia have followed suit, again, a more unified situation and allowing programs like regulatory sandboxes to allow for innovation.

On the other hand, in the United States it is not all bad. Some of our regulators have been making concerted efforts to become more innovation-friendly. We have certain advantages from a commercial perspective.

The fact that we have such a leadership in the I.T. and finance areas help us. The problem is, in other respects, our financial regulatory system creates headwinds that we have to struggle against.

Mr. ROTHFUS. I think I am going to ask Mr. Peters a little bit about the regulatory headwinds that might be out there. You represent a group of companies that are becoming increasingly active in fintech. As you look at the existing landscape, does the current framework we have, from a regulatory perspective, hinder growth?

Mr. PETERS. I would say that, yes, there are challenges.

Mr. ROTHFUS. You talked a little about the standardization. Just give us an idea of what the chief regulatory impediment might be in the space of growing fintech?

Mr. PETERS. It is twofold. One, we have to consider that technology and financial services, whether the tools are coming from my companies as technology companies or they are coming from financial institutions, technology and financial services are fundamentally integrated.

But many of our financial laws were written in a paper or earlier era. Continually we always need to look for opportunities to update, to make our regulatory regime consistent with the modern world that we are operating in.

But, number two, one of the bigger challenges, is just the fractured nature, particularly of State-by-State, regulation. There have been some efforts at the State level, which are commendable, to gain some level of uniformity.

But especially with respect to State money transmission licensing, that is a very significant delay to entry in the market, and it holds consumers back from accessing, ultimately, what they ought to be able to get equally and easily across the country.

Mr. ROTHFUS. Mr. Smith, some people tend to describe fintech as an adversarial development from the perspective of existing brick and mortar banks. When I read your testimony, it is clear that you don't think that is necessarily the case. Can you elaborate on how fintech could actually help traditional banks serve their customers better?

Mr. SMITH. Well, fintech has a special role to play with respect to community banks insofar as the very biggest banks, the credit card issuing banks, for example, already have access to technology sometimes by going out and purchasing the fintech companies. But smaller banks don't have that same luxury.

What we find is that fintech is a way for smaller banks to punch above their weight, to serve customers that they wouldn't otherwise serve, to offer products they wouldn't otherwise offer, to diversify risk in a way that they wouldn't otherwise be able to.

One of the things that we are seeing, and in my written statement I cite to an ABA study that says fintech is really do or die for community banks. ABA estimates that there is a \$100 billion pool of profits for community banks generally.

If community banks are able to capitalize on financial technology to offer new products, they may be able to grow that pie by—the estimate is \$15 billion. If they don't, that pie gets smaller by \$20 billion.

So we are talking about a significant swing in potential profits if community banks are unable to capitalize on financial technology to offer new and innovative products to their customers.

That is a big deal, and that is something that we don't want to jeopardize by depriving community banks of the ability to access financial technology in that way, by partnering with fintech firms.

Mr. ROTHFUS. You bet.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we go to the gentleman from New York, Mr. Meeks. You are recognized for 5 minutes.

Mr. MEEKS. Thank you, Mr. Chairman. Let me thank all of the gentlemen for your testimony today. It is tremendously important what we are discussing.

I would think that from what I have heard, each and every one of you want to make sure that we don't have individuals who are trying to take advantage and/or fraud the system or those that want to harm consumers.

We are trying to figure out a way that we can move forward so that there would be more opportunities for individuals who may not have access to capital.

In the communities that I represent and grew up in, there are not a lot of individuals, whether small businesses or other ones, that don't have access to capital. A lot of banks are not lending to those communities anymore.

I hope that we are not saying that we won't—or anyone is saying—I didn't hear anyone say that we don't want there to be opportunities within those communities for individuals to have access to financial services.

I know from my own lifetime I have seen in the communities I represent where people say that there should be nothing there. We want to protect those folks. When we don't have anything there loan sharks take over.

I want to put the loan sharks and the predatory lenders out of business. That is what all of you all want to do.

As a result, let me ask Mr. Hoopes a question, under current regulation the line between legitimate third-party lending relationships and abusive charter arrangements is unclear.

On one hand, both Democratic and Republican Administrations have encouraged third-party lending relationships because of their potential to expand credit access to underserved communities, of which I am concerned about.

This includes the Cordray CFPB through its non-action letter program. But nevertheless, our banking regulators have also used their current enforcement authorities to stamp out abusive relationships, including past bank relationships with abusive payday lenders.

Can you tell this committee or can help this committee distinguish between your members' partnerships and abusive relationship that regulators under both Democratic and Republican Administrations have discouraged now and in the past?

Mr. HOOPES. Thank you for the question. You are absolutely right. There is great evidence that partnerships between originating banks and marketplace lenders are delivering products to underserved communities, places where bank branches have closed and delivering products that are more affordable than the products that were available from traditional institutions and doing so by

using advanced techniques that go beyond just looking at a traditional FICO score.

Only financial technology companies that are applying those methods can reach those borrowers. To be clear, the bank partnerships are how those loans are being made nationwide.

For almost 15 years now, banks have not been permitted to offer any abusive payday loan or to partner with a payday lender.

The Center for Responsible Lending has said in some of its written materials that prohibition language from the Office of the Comptroller of the Currency has been generally effective in preventing payday lending from coming into the banking system or via partnership.

To answer Professor Levitin's remarks earlier, the legislation Protecting Consumers' Access to Credit Act that you mentioned that you support and many others do as well, cannot become an avenue for abusive lending because the bank can't make the loans, the abusive loans, in the first place. Bank regulators have not permitted such arrangements in their regulated entities.

I think we do a number of things. Marketplace Lenders, again, as I mentioned in my testimony, only issue loans that are in compliance with the FDIC's guidance. Their guidance is that loans must be capped at 36. Again, that makes sense because the bank is the one originating the loan.

Mr. MEEKS. Because I am running out of time, I just want to ask another quick question because I think that we are starting to get the FDIC and the OCC to look and to be regulators, as opposed to having anything that is unregulated, which is what my focus is.

But also, I sent a letter to the OCC which talked about, Community Reinvestment Act (CRA), some of the response to make sure that people are responding to our local communities.

In response to my letter the OCC required that fintech firms, that receive national charters, develop business plans that demonstrate their commitment to serving underserved populations.

Can you describe how important those requirements are toward establishing confidence among fintech lenders who receive the benefits of national charters and moderate income individuals and families?

Chairman LUETKEMEYER. We will give you 30 seconds.

Mr. HOOPES. Absolutely. So financial inclusion is core to the business model of the companies in the Marketplace Lending Association.

To the extent that they are interested in pursuing national bank charters we have gone on record as saying that a financial inclusion requirement that would be a nationwide requirement updating the current CRA framework, makes a lot of sense. It is critical that when given the privilege of a charter that you also have a responsibility.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we recognize the gentleman from North Carolina, Mr. Pittenger. He is recognized for 5 minutes.

Mr. PITTINGER. Thank you, Mr. Chairman. Thank you again to each of you for joining us today and offering your expertise to this committee. It is very much valued.

I would say that I join with others on this committee who believe that the bedrock of our economy is found in the entrepreneurial spirit and the spirit and the choices that are given in the marketplace. To that end, as one who believes in free markets, I believe that it is important that they remain open and competitive.

With that in mind, Mr. Knight, I would ask you to begin with, and others can chime in if they like. What evidence do you see in the existing regulatory environment that hinders future growth to the fintech industry?

Mr. KNIGHT. Thank you, Representative Pittenger. What we are seeing in particular, the State-by-State nature of regulation for money transmission and lending, is causing firms to either not engage, pull back from lending for certain borrowers.

Have trouble either obtaining the necessary licenses because it is estimated to take between 1 to 2 years and \$1 million to \$2 million in certain cases, from engaging in entering the space.

One of the risks we may find is that the only firms that are coming in now are going to be already large and well-established firms, which is fine.

New competition is great, but we also want a place where brand new startups can actually get in and compete. We are seeing that risk.

Mr. PITTENGER. Anyone else want to comment on that? Very good.

I would say this again for all the panel. There has been some talk out there that the fintech industry is unregulated. Is this an accurate representation?

Mr. KNIGHT. Absolutely not. The financial technology industry with the caveat that, of course, fintech is a broad term, but for what we are talking about today there is regulation. There is regulation at the Federal level through the CFPB to the extent there is a bank partnership the bank regulators get involved.

If they are accessing the capital markets, as many of these firms, particularly marketplace lenders will do, the SEC is involved. For cryptocurrency firms they are regulated either as money transmitters by FinCEN and the States, or if they are engaged in commodities transactions the CFTC has jurisdiction. If they are engaged in securities transactions the SEC has jurisdiction.

The FTC has jurisdiction over certain areas. There have been numerous enforcement actions in the financial technology space. So to say that it is unregulated is inaccurate.

Now, to say it is regulated exactly the same as banks is not necessarily true either, but then we need to ask what are the relevant risks? Are the relevant regulations the same?

So for example, fintech lenders are subject to Truth in Lending, Equal Credit Opportunity Act, all of the Federal consumer protection laws engaged in lending.

They are not subject to the same safety and soundness requirements as banks because they don't have Federal deposit insurance. They don't take deposits. They don't have access to the discount window.

So they are not generating that type of risk. The risk they are generating is a consumer protection risk, and they are subject to the same consumer protection laws.

Mr. PITTENGER. Very good.

Mr. LEVITIN. May I add something to that?

Mr. PITTENGER. Yes, Professor.

Mr. LEVITIN. I would agree with everything that Mr. Knight says, but fintechs are subject to the same laws but not to the same supervision mechanism.

The CFPB has supervision authority actually going and doing exams over large banks. It does not over most fintechs.

Mr. PITTENGER. Thank you. I need to move on. I have less than a minute. I would like to ask what can Congress and prudential regulators do to facilitate the adoption of fintech to the U.S. without putting consumers at risk?

Mr. Knight, you can proceed on that if you like?

Mr. KNIGHT. Sure. So among the things they could do is, as mentioned previously, create an environment where firms can innovate while maintaining appropriate consumer protection.

We can provide certainty to the relationships with banks. We can streamline the licensing requirements. The answer might be something like the OCC charter. We should also look at ways to allow State-licensed entities to operate on a national basis, like we do with State-chartered banks.

Mr. PITTENGER. Thank you.

Mr. Hoopes, I would just ask what can be done to help grow our local communities, particularly rural areas? I have a very rural part of my district.

Mr. HOOPEES. Absolutely. Marketplace platforms are available to borrowers wherever the Internet is available. One of the initiatives that we are supporting is rural broadband access.

We think it is one of the only ways that a borrower is going to find us, rather than a potentially worse product at a local storefront or strip mall, is if they can access the Internet. So, that is a key initiative for Congress to continue to work on.

Mr. PITTENGER. Thank you.

My time has expired.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we recognize the distinguished gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. Welcome panel.

Fintech, no question about it, is really dramatically reshaping how Americans are now receiving their financial services and doing an excellent job of that.

Nowhere is that more poignant than in their capacity to be able to help, work, and partner with traditional banks so that they can better serve underserved communities at a reduced cost.

You take Kabbage, for example, in my city of Atlanta, doing a remarkable job using their innovative capacity of the speed of their computers to do wonderful things like helping people that they pay their loan back faster. They get a reduced cost. All of that is going well.

But there are critics out there who are saying that there should be more protection and that protection should be at the State level. But here is the problem. We have 50 States. They vary from State to State.

On top of that you have the OCC moving for a charter for these fintech companies. You have them all chomping at the bit now to regulate from the OCC, CFPB, Treasury, the Fed. This is getting to be very problematic.

So let me ask you, Mr. Smith, what do you say about this? How does this patchwork, this whole situation could lead to increased cost and do just the opposite?

Mr. SMITH. Well, you are right. Thank you for the question, first of all, and you are right that the patchwork of regulation can lead to stifled innovation, and it has. One of my biggest concerns is that it can be so prohibitively expensive to build a national platform on a State-by-State basis that it becomes an enormous barrier to entry for a new firm with a bright new technology.

So as an example, I am a lawyer here in Washington, DC. We advise a lot of companies on these issues. Conservatively it would take 2 years and a couple of million dollars to license and build a platform through the State-by-State licensing system.

Now, the other problem is that many States don't even permit you to offer certain of these products. So, offering a credit card, for example, through a State licensed model would be impossible. But what we have in this country are a variety of different regulatory models, so the State-by-State model works for some.

For some being a bank works. For others partnering with a bank can work. We want to make sure that we preserve the benefit of all of those regulatory systems.

By partnering with a bank it is not a free pass for a fintech firm. You are going to be subject to this pervasive scheme of Federal banking oversight, Federal banking agency oversight, including direct examinations of the fintech firm itself. That is quite substantial.

I don't see why we wouldn't. If we have an opportunity to put people in a good bank product, why wouldn't we do that? Why wouldn't we capitalize on that?

Mr. SCOTT. Well, thank you. Thank you, Mr. Smith.

Now, Professor Levitin, in your statement you said that fintech companies can be risky and fraudulent. We need to hear you. How so? Because this is an important hearing and that is the one thing we do not want our fintech companies to be. So could you tell us what you mean by that?

Mr. LEVITIN. Sure. On its simplest and easiest level we can just take cryptocurrency companies. We have seen plenty of fraud in the cryptocurrency space, and it seems to be growing, where consumers invest—

Mr. SCOTT. You said crypto space?

Mr. LEVITIN. Cryptocurrency, things like Bitcoin and Ethereum, all kinds of—I am not quite sure how to describe them other than cryptocurrencies. Where sometimes people think that—

Mr. SCOTT. We are moving very fast.

Mr. LEVITIN. I am going to try and move fast. I see that the time is running out—where people are deceived about the nature of the investment that they are making.

It is important to note on the lending front the use of bank partnerships has one and one purpose only, and that is the evasion of State usury laws.

That there may be reasons to question about State usury laws, but we should—if we are going to have fintechs operating in that way there should be a Federal standard that they all have to comply with.

Mr. SCOTT. OK. Mr. Smith, do you agree with what he said?

Mr. SMITH. No, of course I don't.

The purpose of bank partnerships and bank relationships is to expand access to consumer access to innovative products and help banks compete better.

Mr. SCOTT. Thank you, Mr. Chairman. I appreciate it.

Chairman LUETKEMEYER. You slipped an extra one in there, Mr. Scott. That was pretty slick. The gentleman's time has expired.

With that, we go to the gentleman from Kentucky, Mr. Barr, Chairman of our Monetary Policy Committee. He is recognized for 5 minutes.

Mr. BARR. Thank you, Chairman. Appreciate you holding this very important hearing, and obviously fintech has tremendous potential and promise to enhance financial inclusion, to help unbanked and underbanked individuals in this country access financial services that they otherwise would not have access to and the promise for low-cost financing and the speed of payments.

This is a really innovative space, and it occurs to a lot of us here as we look at how to improve the regulatory framework we should first do no harm.

Mr. Knight, this concept of a regulatory sandbox is intriguing to me. The fact that it has been tried in other jurisdictions successfully without compromising consumer protection is interesting so that we can foster innovation in this space.

Let me either start with you, Mr. Knight or Mr. Smith. I want to explore this *Madden v. Midland* decision a little bit more and understand it a little bit more.

Can either one of you—well, let us start with Mr. Knight since you have written extensively about this decision in the 2nd Circuit. Can you discuss this valid when made doctrine and why it would be important to codify that decision?

Mr. KNIGHT. Thank you. So—

Mr. BARR. Or that doctrine rather to overturn the decision? Sorry.

Mr. KNIGHT. Yes. Please don't codify *Madden*.

Mr. BARR. Right.

Mr. KNIGHT. So the issue is whether or not a loan that was valid when it was made, so a legal loan that the law, the borrower, the lender all agreed was OK, can subsequently become usurious and invalid, not because the obligation to the borrower has changed in any way, in any material way, but because the loan is sold to a third party.

In *Madden* what happened was it was a credit card that defaulted and the credit card debt was ultimately sold to a debt buyer who sought to collect on it.

While the loan was valid when held by the bank under Federal law, the 2nd Circuit found that the loan had subsequently become invalid, not because the loans terms had changed but because the ownership of the loan had changed.

The obvious problem there is if you have a situation where a bank wants to sell a loan, be it to a fintech firm or a debt buyer or potentially in the securitization market, and the buyer is not a bank in a State where that loan would have been valid based upon the the bank's home State usury law, it calls into question the validity of the loan, which cuts off or risks cutting off funding because people are not going to fund loans that they think are going to turn out to be—

Mr. BARR. Can you speak to the impact and the holding of Madden in terms of credit markets? Has there been any identifiable impact on access to credit for either consumers or small businesses as a result of that decision?

Mr. KNIGHT. Yes. Three professors in an article that is forthcoming from the University of Chicago Journal of Law and Economics, studied the impact of Madden in New York and Connecticut versus the rest of the country and found that for marketplace lenders, they were seeing less funding for loans for borrowers with relatively low credit scores compared to the rest of the country.

Mr. BARR. OK. So let us go to the lawyers real quick.

Mr. Smith, obviously Professor Levitin and other critics have expressed concerns that these loans made by banks through their fintech partners are really just an attempt to provide a backdoor rent-a-bank model for payday lenders.

But isn't it true that the loans that would be regulated, that these loans would be regulated just like all other loans made by that bank, including the oversight by all the Federal regulators, the FDIC, the OCC, the Federal Reserve, not to mention the CFPB?

Mr. SMITH. Right. To the extent the CFPB would have jurisdiction over the bank. CFPB doesn't examine less than \$10 billion in equity. Yes.

Mr. BARR. Sure, but the point is those banks are regulated.

Mr. SMITH. Right.

Mr. BARR. And that loan, valid when made loan, is regulated.

Mr. SMITH. That is absolutely right, and the FDIC has been a bulldog on this idea that it doesn't matter if the bank originates the loan in partnership with a fintech firm. All of that activity that happens to originate and service the loan, that is as though it is happening inside the bank. It is going to be examined in the same way.

Mr. BARR. So when we talk about financial inclusion and access to affordable financial services, rural areas—I represent a rural area in Kentucky.

How important is it to community banks, credit unions, particularly in rural or underserved areas, to have access to these relationships with these fintech companies to serve their customers?

Mr. SMITH. Well, for the community banks originating loans, servicing loans, that is complicated. It is particularly complicated when you are doing it over a mobile device or over the Internet.

These community banks they don't have that know-how. The credit unions, the same way. Credit unions operate frequently through organizations called CUSOs, Credit Union Service Organizations.

But they outsource everything. They outsource all of the marketing, all of the origination, all of the servicing, and they need to have access to these services in order to continue to offer these products to their customers.

Mr. BARR. My time has expired.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we will go to the gentleman from Missouri. Mr. Cleaver is recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman, and to the Ranking Member Clay. I am not a member of this subcommittee, but the Chair was kind enough to let me participate since our side is almost finished. So I will try to be economical with the time I have been given.

This issue, as I don't have to tell any of you, affects many Americans even without them knowing it. It has the potential to either dramatically expand the playing field for funding new ideas from all corners of the country if it is done correctly.

We also have to deal with problems that may emerge, and that is why I hope this hearing today will be just the first, Mr. Chairman, that Congress convenes on this tectonic but consequential issue. And that it will ultimately end with commonsense legislation.

It may be of some value for us to know that South Korea has already issued rules on cryptocurrency. My concern is that if we are not clever and smart we are going to end up seeing a lot of the countries which whom we do business actually moving further than we have in this arena.

This is serious stuff. I am also concerned that while I have some concerns about fintech, I do believe that the financial technology is a force of good in this country and not a foreboding force for expanding and exacerbating racial and income inequality in the United States.

We can't hold back the waves of progress. They are coming. We need to be ready to deal with them as quickly as we can. I would like to ask a question.

Professor Levitin, at the end of your testimony you discussed the importance of the Consumer Bureau moving forward to implement Section 1071 of Dodd-Frank and collecting small business lending information.

Would you please discuss why this is important and how having less data in the small business lending space makes it infinitely more difficult for policymakers to assess what adjustments may be needed?

Mr. LEVITIN. Well, I would hope that everyone in this room would support evidence-based regulation, that we want to be regulating based on facts not based on just the way we think the world ought to work.

We can't do that unless we have data. Unfortunately there is not very good data that is currently available about small business lending.

Marketplace lending, a lot of it is either formally small business lending or functionally small business lending. A contractor who operates just as a sole proprietor who might borrow money to pur-

chase a pickup truck that he is going to use to drive his kids to school, but also that he is going to use for business.

Is that small business lending? Arguably so. Any which way, if we want to do good regulatory policy we need to know what is going on in small business lending, and particularly we want to know if there is discrimination in small business lending.

Are small business people of color, women-owned small businesses, are they getting credit on the same terms and with the same ease as other small businesses?

We have no way of knowing without the Section 1071 data collection. It is a shame the CFPB hasn't started that collection already, and I would urge the current leadership of the CFPB to take action on it.

Mr. CLEAVER. Yes. My concern is not that there is this wolf-like intentionality to discriminate against certain groups, but that when we are dealing with algorithms we are putting down opinions and ideas from human beings that play out.

I appreciate the time, Mr. Chairman.

Thank you all for being here.

Chairman LUETKEMEYER. The gentleman yields back his time.

With that we go to the distinguished gentleman from California, Mr. Royce, the Chairman of the Foreign Affairs Committee. He is recognized for 5 minutes.

Mr. ROYCE. Thank you very much, Mr. Chairman.

Mr. Hoopes, technology of course can improve the quality of underwriting and obviously then lead to more accessible loans, more affordable loans. So I introduced this bill. It is a bipartisan measure, the Credit Score Competition Act.

What that does is to mandate that the GSEs modernize their acceptance of new credit score modeling in order to evolve into a circumstance where the products that can offer information, like telephone bills, utility bills, and those are the obvious ones, but the industry understands there are many, many other risk correlators out there that really would help those underserved consumers who have very thin or nontraditional credit histories.

So that is the concept. So could you discuss the benefits of technology to the underwriting process as it applies to that goal? What obstacles might exist for fintech applications to build on these platforms and maybe reference the concept behind the legislation?

Mr. HOOPES. Absolutely. So what my members have found is that FICO is not particularly predictive. They have moved beyond FICO in their modeling.

Obviously traditional metrics are still used, but additional data points have proven to help my members move borrowers, who if analyzed by a traditional player would have considered them subprime, and moved them into more of a prime bucket in terms of the pricing that they are getting on credit.

The only way they are able to do that is by assessing a variety of data points and finding ones that suggest that the person will be responsible, more responsible even than their thin credit file would originally suggest.

So the purposes of the legislation are absolutely right on for what our members have experienced in the financial market.

Mr. ROYCE. Thank you.

My second question, my last question, I am a very strong believer as we have had these debates in the past here in the committee, that effective regulation of interstate commerce should be done on a very uniform basis.

This doesn't necessarily mean a national regulator. It could mean at the very least those standards set by one body. By the way, I don't believe this only applies to financial technology marketplace issues. It should apply—it is a basic economic principle.

So in the past, jurisdiction-by-jurisdiction regulation has led to a situation where we have political pull and over-politicized and balkanized laws, very clearly, that lead to inefficient markets. Obviously it leads to barriers of entry or at least manipulation in order to prevent entry into a market.

You see incumbent interests trying to block fresh faces from coming into these markets. You can see how they do it. So how do we avoid this outcome in the fintech space?

I guess a national charter might be one concept. You could look at the industrial loan company charter as a model or other models along that line. But I would just like to ask the panel for their thoughts very quickly on this?

Mr. SMITH. So I agree 100 percent with you in your misgivings about State-by-State regulation. On the other hand, what we have in this country is a multiplicity of regulatory models and some models work for some players, other models work for other players.

So State-by-State licensing always has a place. Becoming a bank always has a place. Getting an industrial loan company charter always has a place. Partnering with a bank should—we should make sure that we ensure that fintech firms are able to partner with banks.

Banks are able to partner with fintech firms and not have courts come in after the fact and unravel those transactions and decide that, in fact, someone else, not the bank was the true lender.

Mr. ROYCE. Other commentary?

Mr. PETERS. I would just say quickly for financial innovation, what we appreciate is the idea of optionality, that there be many options available. So when we recommend that there be a Federal money transmission license that it is optional.

So that those who choose to go through the States can still do that if they want. It is that optionality in the system that would be beneficial to, as Mr. Smith said, the specific business model depending on how it is arranged.

Mr. HOOPES. Well, I will just jump in also. I couldn't agree more. Just to put a finer point on how unprecedented the Madden decision was. The idea is not that the banks can't make the loans.

It is simply that they can only sell loans that were made in certain States to certain borrowers. You talk about balkanization. You simply can't operate that way.

Mr. ROYCE. Thanks. Thanks, Chairman.

Chairman LUTKEMEYER. The gentleman's time has expired.

With that we go to the gentleman from Texas. Mr. Green is recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing. I am interested in knowing more about steps that have been taken, Mr. Hoopes, by your association to benefit consumers

and self-regulate. Can you please give some indication as to what you are doing please?

Mr. HOOPES. Absolutely. The core on the small business side is the small business borrower bill of rights. That, again, that I mentioned earlier, is a joint effort with for-profit entities in the association and also non-profit entities like Accion and the Aspen Institute to really look at from the perspective of the small business borrower.

It is a little bit of the Golden Rule. If you are a small business and you have a million things to worry about, being duped by a financial institution probably isn't one of them.

So that effort is part of our criteria for membership, so you have to adhere to those standards or you have to find an equivalent standard. So that is around things like disclosure of APR. Again, APR is a way to compare products across terms.

Do I want to take out a series of 2-month loans at maybe a higher APR or do I want to take out a single loan that might be a larger dollar size at a lower APR that is longer term. Being able to compare products is a key part of choice.

Candidly in the small business area a lot of the consumer protections, we heard earlier how in small business lending and consumer lender, start to merge in very, very small entities.

That effort, that self-regulatory effort, while it hasn't been adopted by the entire industry is an effort to say that those small business borrowers are people too and so they deserve the protections that come with disclosing upfront APR, disclosing if there are any pre-payment penalties or fees.

Making sure that people know what they are getting themselves into and really right-sizing the financing so that you are only being able to be a profitable lender when your borrower is set up for success, as opposed to set up for failure.

Mr. GREEN. Do you believe these to be beneficial to the consumer as well as to the members of your association?

Mr. HOOPES. Well, absolutely. I think that educating—

Mr. GREEN. Let me just follow up quickly because I have another question. If this is the case, how would you have all of the businesses adhere to what you believe to be reasonable policies?

Mr. HOOPES. Sure. So we don't think that our initiative is the only way that you can skin the cat. There are other ways potentially to offer robust disclosure that inform borrowers what they are getting themselves into. I think greater education.

This type of hearing is a way that people can be made aware of the differences between players that are online or acting through storefronts.

Mr. GREEN. Allow me to intercede and ask another question. Do you think Congress has a role to play in regulation?

Mr. HOOPES. It does.

Mr. GREEN. OK.

Let us move to Mr. Levitin. Let us talk about the risk associated with the cryptocurrencies and that is not a term that I find favor with. I am not sure that we are dealing with a currency, but for our purposes and for this hearing, what are some of the risks that we have to concern ourselves with?

Mr. LEVITIN. I think the largest one is simply fraud. That consumers are going to be duped into investing in cryptocurrencies that they may not understand or that even if they understand that there is theft within by a cryptocurrency player.

Beyond that though, even when there is not fraud or not theft, there is a tremendous investment risk in cryptocurrencies. I think what we have seen with Bitcoin prices over the last year is a classic example of extreme volatility in an investment.

It is not a particularly suitable investment for most consumers, and I worry that you have consumers who don't really understand the risks, even when there was an outright fraud, but they don't understand the risks they are taking by investing in cryptocurrencies.

I would also add one other thing which is a major use of cryptocurrency is money laundering. Beyond speculative value that is really the major purpose for the use of cryptocurrencies and that is not something that we should want to encourage.

Mr. GREEN. I completely agree.

My time is up, so I will yield back, Mr. Chairman.

Chairman LUETKEMEYER. This gentleman's time has expired.

We will now go to another gentleman from Texas. Mr. Williams is recognized for 5 minutes.

Mr. WILLIAMS. Thank you, Mr. Chairman and for holding this hearing in the financial technology industry, which has shown tremendous growth since 2010 and is becoming increasingly important to individual consumers and small businesses alike.

This segment represents the new opportunities in the communities I represent, and I am interested to find out more about the future of this industry segment and the role Congress plays. We are doing a good job of that today, and I want to thank all the witnesses for being here and your expert testimony.

My first question is to you Mr. Smith. I would like to take a few minutes to discuss the impact that fintech has had on community banks. As a member of this committee I continue to fight for community banks and small institutions that are the backbone of Main Street, which I represent.

In your testimony you discuss that banks often choose to partner with already existing fintech companies rather than enter these markets on their own because they would incur great expense.

So what factors can you identify that contribute to that great expense? Does it have more to do with technology and not knowing the market or other costs that push banks toward partnerships with fintech companies?

Mr. SMITH. Well, so the first issue is the technology that you mentioned. Offering these products through an electronic platform is a complicated thing to do. So what we are talking about here is marketing, originating, servicing a credit product electronically.

That is something that a community bank wouldn't necessarily have the expertise to do on its own without help from an outside fintech firm or without spending millions of dollars and years to develop its own technology.

Now, of course, the biggest banks can do that. But it is the small banks that need to rely on others to help them offer these products.

The other issue is liquidity. Smaller banks need capital, need people to whom they can sell these loans, whether it is participations in the loans or the whole loans, in order to get back to the business of lending.

They can't be overexposed to any particular set of credit risks, and they need to be able to sell these loans so that they can deploy their capital back in the lending business. I want to caution though that there is a lot of talk about how banks are no longer at risk. That is not right.

When a bank originates a loan, the bank is always on the hook as the original lender for Truth in Lending, for unfair deceptive practices, for fair lending.

In addition, banks frequently have credit risk, either because they retain a participation, because they have repurchase risks, or because they have what is called pipeline risk where there are concerns that their counter party may not have—and this is outlined in fact in Professor Levitin's testimony, that the counterparty that stands ready to purchase these loans may not be able to make good on its obligations. So there is risk there, too.

So it is not a free pass for banks. It is not a free pass for fintech firms, but it works for consumers.

Mr. WILLIAMS. OK. Next question also, Mr. Smith, one section of your testimony that stands out to me is the study you highlighted by the American Bankers Association, which says by 2020 community banks could lose as much as \$15 billion to fintech firms and other banks going digital.

On the flip side if they adopt fintech, and we have talked about this, they could gain as much as \$20 billion in revenue by 2020. So those numbers are pretty dynamic.

What kinds of new business is created when community banks go into the fintech space, and what kinds of customers can they serve that they would not otherwise?

Mr. SMITH. So my focus in the testimony is on credit partnerships and lending partnerships, but I think that any financial product—whether it be a prepaid card or a peer-to-peer payment service, all of these bank products, deposit taking over the Internet, all of these bank products—can be offered through the use of financial technology and community banks.

There is no reason why community banks can't do that too as long as they have the know-how.

Mr. WILLIAMS. OK, another one for you. You identified the good that community bank partnerships with fintech can bring, but in your testimony you also mentioned that there are problems.

One of the most prominent obstacles, your point, as you pointed out in your testimony, was the uncertainty over inconsistent true lender decisions. I agree with you that without that certainty, market participants might not be willing to enter the market so this can have the ripple effect of hurting consumers and banks alike.

So real quick, to what extent would the Modernizing Credit Opportunities Act proposed by my colleague from Indiana, Mr. Hollingsworth, solve this problem?

Mr. SMITH. Well, so in theory there is no problem. I think that the law is crystal clear on this subject that if a bank makes a loan

then the bank is the lender. But apparently some courts are being led astray, and when I say some I mean a very few.

We have several cases that address this issue. In many of those cases the court has said, yep, I am looking at the loan. The bank is the lender. That is the end of the story.

A couple of other courts though have said, no, let us look beyond this transaction. Let us figure out who has the quote/unquote “predominant economic interest” in the transaction. And that is the rub. That is where the uncertainty comes in.

We need to make sure and I think Mr. Hollingsworth’s bill would do this effectively, to basically reinforce what we all know that the law already requires.

Mr. WILLIAMS. Thank you for your testimony. I yield.

Chairman LUETKEMEYER. Mr. Williams’ time has expired.

With that, we go to the gentleman from Washington. Mr. Heck, is recognized for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman, very much.

I would like to begin by asking each of you to answer very briefly how you define fintech space. It just seems to me that this is incredibly amorphous, and in order for us to begin to make progress on advancing our thinking about how we may or may not need to update regulations we ought to have a sense of what this is.

So starting with you, Mr. Hoopes and going down the line and briefly please, I have a couple of other questions. How do you define the fintech space?

Mr. HOOPES. I guess, I will focus on lending since that is what we do. In lending I think the fintech space is, firms that are offering credit and using processes, all the Internet, technology-enabled machine learning to really transform the experience for the borrower.

Then on the flip side also create opportunity for investors. Again, all done in a way that is remarkably different, faster, more efficient, more transparent than previous examples.

Mr. HECK. Speaking of being faster, quicker, more efficient, because I really want to hear briefly from each of you. Thank you sir.

Mr. KNIGHT. So most broadly the application of technology to the provision of financial services. For these purposes the provision of financial services by non-banks via non-traditional underwriting or delivery mechanisms.

Mr. HECK. Mr. Peters?

Mr. PETERS. Well, I actually agree with you and don’t use the term fintech as often as I can. I try to avoid it. For us it is using technology to make people’s lives simpler and safer.

Mr. HECK. Mr. Smith?

Mr. SMITH. So I have a prop here. To me it is offering financial products and services to consumer and small business over this.

Mr. HECK. Over a mobile device?

Mr. SMITH. That is it.

Mr. HECK. Professor?

Mr. SMITH. And everything that goes along with it.

Mr. LEVITIN. I am going to try and do this in 280 characters or less. Non-bank financial services companies without a brick and mortar presence.

Mr. HECK. So it seems to me that there are a lot of different businesses that are in this space. You have mobile payment, mobile banking, which really rests right on top of banking. You have marketplace lenders who are literally in direct competition.

Theoretically you also have cryptocurrencies which could serve, if they were completely robust, and I am not suggesting they ever will be, to replace banks.

Do I have that about right, Mr. Peters?

Mr. PETERS. My companies look at blockchain and the technology and we find it very interesting, but we take no position on it.

Mr. HECK. The question wasn't whether you have a dog in this fight. The question was whether or not if they were ever fully developed they would, in fact, be replacing banks.

Mr. PETERS. We just don't have a position or opinion on it.

Mr. HECK. I didn't ask you if you were for or against it, Brian.

Mr. PETERS. For us the underlying technology is very, very interesting and very compelling. I think we are watching it develop.

Mr. HECK. All right. So for anybody who wants to answer this question, I have been paying a lot of attention to the push to finally get to the point where we make faster payments, an area of financial transaction where we ride the rest of the world, frankly.

I was interested recently to learn that the Fed actually levies a fee for anything that is posted after 5 p.m. I wondered if that was an example of an impediment to getting to faster payment?

But more broadly, I would be interested if any of you have, very quickly as time is winding down, examples of other regulations that might keep us at the Fed level or anywhere else from getting to the faster payment scheme much like the rest of the world.

Professor, let us start with you and go down the line in 50 seconds.

Mr. LEVITIN. Well, I am not sure I have an answer that is directly on point to your question.

Mr. HECK. OK.

Mr. Smith?

Mr. SMITH. The same.

Mr. HECK. Mr. Peters?

Mr. PETERS. I don't think it is just the regulation that needs to be removed. I think the Fed is shepherding a very commendable process to get industry, through an industry-like solution here.

They are shooting for 2020. There will be a variety of solutions that come to market and hopefully, we have interoperability and ubiquity of faster payments by that date. That is something we care very much about. It matters.

Mr. HECK. You want to see it happen.

Mr. PETERS. We do, absolutely.

Mr. HECK. Mr. Knight?

Mr. KNIGHT. So the product of regulation, one of the challenges we face, is the number of F.I.s we have in this country relative to other countries. If you look at the countries that have done faster payments, they have few large F.I.s rather than many relatively small F.I.s like you see here.

Mr. HECK. Mr. Hoopes, in the time I do not have remaining?

Mr. HOOPES. The IRS Data Verification Modernization Act would enable much faster disbursement of loans. You would be able to,

as a lender, verify somebody's income when they have already agreed to share that information.

Mr. HECK. Thank you, Mr. Chairman. I am yielding, evidently.

Mr. LOUDERMILK [presiding]. The gentleman yields back his time.

The Chair recognizes himself for 5 minutes for questioning.

I find ourselves in an interesting position, but not a position we haven't been in before in America. Recently, I read an old newspaper article from the early 1900's from a very prominent national newspaper that said humans will never fly and shouldn't. This was at the time when two bicycle mechanics from Ohio were attempting to fly, Orville and Wilbur Wright.

I see where we are in the fintech industry, especially from someone who spent 20 years in the I.T. business. In an interesting position, because this is a consumer-driven solution to a demand by consumers to apply technology we have available, as was said earlier, to make their lives better, simpler, and provide something that, because of various reasons, much being government regulation, that traditional financial institutions couldn't provide them in many cases.

We often find ourselves where traditional bureaucrats or government regulators find themselves, in a position where they are trying to put a round peg in a square hole.

This new industry, this new technology which is demanded by consumers and many of the younger generation is we find ourselves in government telling them, no, you can't have what you want because it doesn't fit the traditional model or ideas that we have.

We find ourselves uniquely in this position again of how do we bring these ideas and these technologies to fruition which the market has brought themselves, but to ensure that the consumers are protected.

It requires government to catch up with the time, which is very difficult to do sometimes.

Mr. Hoopes, some, including Professor Levitin, have stated that bank-fintech partnerships raise concerns about safety and soundness and consumer protections. Is this accurate, and can you explain a little more about the relationship between banks and fintech?

Mr. HOOPES. Sure. It is absolutely not accurate. If anything, a bank partnership brings additional regulation and supervision onto a fintech. That is pretty clear. The FDIC, in the case of State charter banks or the OCC, has the ability to directly supervise third parties.

Mr. LOUDERMILK. [presiding]. OK, thank you very much. I do appreciate the illustration somebody used about this device, because our world revolves around this device.

This device is really an empowerment of the individual. You can do everything from booking a flight and a hotel and planning your whole vacation right here on this device. It has become the lifeline for many people in America today.

I have often thought if you applied the regulations that we have applied to things from health care to everything else to this, you

would actually have a revolt by many Americans, because the restrictions it would add.

But another concern I have in the remaining time is as we migrate to more technology, security becomes a greater issue because we do tend to consolidate a lot of information, which is one of the advantages of blockchain technology in whatever area we are going to utilize that.

Mr. Peters, I know that in your comments you addressed some security concerns, and as you know, the expansion of EMV chip technology on payment cards has increased acceptance by merchants and has resulted in significant decline of point-of-sale fraud. However, on the online marketplace this has been increasing. What can we do to help in the online sector?

Mr. PETERS. It is a good question. Obviously, as I mentioned, we are security companies first and large organizations come to our companies, Northrop Grumman, the CIA. They believe that we know what we are doing when it comes to security.

As you pointed out, on that device that we all have in our pockets or on our wrists or maybe elsewhere through a voice assistant, we are adding layers and layers of security to that, whether it is encryption, whether it is biometric authentication. In the applications themselves there are a whole host of security measures in place.

So we believe that in the online environment, there are actually many more opportunities, many of which we have been developing now for years, to ensure that you do have actually a higher level of security and authentication than you may have in the brick and mortar environment.

From a policy perspective, I would say that our system right now is, in terms of the pricing around security and fraud reduction, is somewhat arbitrary.

It would be worthwhile for the committee to explore a way to align the incentives of security for merchants and for banks and card networks around that, rather than an arbitrary level.

Mr. LOUDERMILK. [presiding]. OK. Thank you very much, and my time has expired.

The Chair now recognizes the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you so much, and I thank you and the Ranking Member for calling this hearing and all of the participants.

First, I would like to ask Professor Levitin, one of the cautionary tales about fintech that you cited in your testimony, was the bitcoin exchange called Mt. Gox. Back in 2014, Mt. Gox was the largest bitcoin exchange in the world.

But then someone hacked the exchange, and stole \$450 million, as in million, worth of bitcoins. They disappeared in thin air, and the exchange collapsed overnight and many people lost their hard-earned earnings.

I am extremely concerned about virtual currencies like bitcoin, because a great number of average investors are pouring their life savings into virtual currencies, and they stand to lose a great deal of money when this bubble eventually bursts, as nothing is backing it up now.

People are treating these things as investments, when they are just currencies. And that, in my opinion, is a big problem, because there are absolutely no protections for these investors like we have in stocks and bonds.

So I am working on a bill that would treat virtual currencies that are being used as investments as securities so that investors will get basic investor protections, like adequate disclosures and rules against market manipulation and market fraud.

But another big problem in this space, which you highlighted with the example in your testimony of Mt. Gox, is that the virtual currency exchanges are constantly being hacked. Just last weekend, another virtual currency exchange in Japan was hacked, and they lost over \$550 million worth of virtual currency, the largest cyberheist in history.

So my bill would also subject virtual currency exchanges to exchange-like regulation by the SEC, including robust cybersecurity standards to ensure that these massive cyberheists stop happening.

Now, in no way do I want to interfere with the innovative technology that is coming into being through these currencies, but this doesn't hamper that, which has great promise for the future.

So my question, Professor Levitin, is do you think that we should just let virtual currencies continue to be the Wild West with no protections whatsoever, or do you think we need to start taking some precautions on virtual currencies so that people don't lose their entire savings in these markets, which has been happening?

Then I invite others to give us your comments and beliefs on what is happening.

Mr. LEVITIN. Mrs. Maloney, I believe you are exactly right that there needs to be a regulatory framework for virtual currencies or cryptocurrencies.

I think there is a fine line, though, between creating such a regulatory system and putting a stamp of legitimacy on virtual currencies as investments, and I think one would want to be careful about that.

Of course, if they are regulated in a safe and prudent fashion, then I think the concerns about legitimizing virtual currencies as an investment are reduced.

I think it is important to note that any securities law-based regulatory regime, doesn't in any way reduce the potential benefits from the underlying blockchain technology.

This is any securities-based regime would be about the use of virtual currencies as investments and the underlying technology that has been used for a lot of other things would not be affected by it.

Unfortunately, there is not any good solution for the hacking problem. We can have legislation directing optimal security standards, but the nature of hacking is it is not always preventable. It is just how well can a company fortify itself so that it is a less inviting target than some other company?

I think this is going to be a problem that is going to bedevil financial regulation, not just a virtual currencies, but also banks are common targets for hacking. I think this is going to be a problem going forward for quite a while.

Mrs. MALONEY. Would anyone else on the panel like to respond? No? OK.

My time is up. Thank you.

Mr. LOUDERMILK. [presiding]. The Chair now recognizes the gentleman from Indiana, Mr. Hollingsworth, for 5 minutes.

Mr. HOLLINGSWORTH. Well, good afternoon. I appreciate everybody being here. I have to tell you, so I have listened to much of the testimony and am still really excited about the opportunities that could be afforded by the expansion of fintech, frankly, the opportunity for more and more individuals across this country to get access to credit to use to build a better future for themselves, for their families, and for their communities.

Frankly, this is exactly what we have seen technology do in a variety of spaces. Enable and empower companies to reach consumers that they wouldn't otherwise be able to reach, because we are lowering the transaction costs.

Instead of having to build a huge branch in a local small town community, like I have all the way across my district, we are enabling these products, these offerings to be made over the rails of existing technology.

We are finding people who may, by traditional standards, have challenging credit scores or challenging situations, but through new algorithms, new technology, and new capabilities are saying they might be great credit risks for these type of products.

I am excited about that, and obviously in participating in development of that through my Modernizing Credit Opportunities Act, which I recently introduced as a bipartisan piece of legislation to help ensure that this opportunity remains robust for technology companies to be involved in.

Mr. SMITH, what I wanted to ask you was, a lot of things have been said about this particular piece of legislation, but the reality is we are not breaking any wild new frontier ground here with regard to this legislation, but rather re-enforcing what has been an existing precedent and principle for many, many years and ensuring that same principle applies to this operation just because it is technology. Is that right?

Mr. SMITH. That is right. That the law is very clear where the bank makes the loan, where the borrower agrees to repay the bank, the bank is the lender.

Mr. HOLLINGSWORTH. Right.

Mr. SMITH. That is the end of the story. You shouldn't be guessing at the motives or intentions of all of the different participants to this transaction.

If what we are talking about is making a loan to a consumer over this device, there are a lot of different people who play a role in that, and there is a lot of different expertise that plays a role in that. The bank has to hire out for that expertise.

Banks have always done this. So big banks have tens of thousands of service providers. Nothing different than what we are talking about here. Bank asking others to help it provide innovative products to consumers and to small businesses.

Mr. HOLLINGSWORTH. Absolutely. So again, this is the same product, in effect, sometimes different offerings, but the same basic product that is being offered by banks all the way around the world. That has always been offered by lending institutions.

It is run over new and innovative rails, in effect, that lower those transaction costs and enable them to reach deeper into communities, whether that is small rural communities like I have in district, or whether it is in more urban densely populated areas that might not otherwise be able to reach all those communities.

But ultimately it is the same basic product, same basic principles applying and the legal precedents that have been in existence and allow the secondary market to flourish. We are just saying those same principles need to apply here. Is that right?

Mr. SMITH. That is right. I would say though that this financial technology enables banks, particularly community banks, smaller banks, that wouldn't otherwise have access to this technology frequently to offer new products.

So to offer an open-end product, rather than a simple personal loan or to offer an auto loan. Or to reach, as you say, different communities, different people through different channels.

Mr. HOLLINGSWORTH. Yes.

Mr. SMITH. So those aspects of it are new, but the bottom line is it is credit. Here is the other bottom line. If it is being offered by a bank, it is being supervised by a Federal banking regulator.

Mr. HOLLINGSWORTH. Right, right. You bring up a great point, because not only will this enable more people to be able to have access to credit than otherwise wouldn't be able to, but also open up the number of products that they might have access to. Because no single product fits everybody.

I have different needs in Jeffersonville, where I am from, than an hour and a half north in the suburbs of Indianapolis in Greenwood. Those needs are very different.

We used to have community institutions that served those particular needs, and we have become more and more challenged because of some of the regulatory framework to have those individual community institutions serving those communities, serving those individuals with unique and different products. This is really going to open that up.

With the small amount of time that I do have left, I would like to enter these letters of support into the record: This one from the Innovative Lending Platform Association, this one from Consumer Research at Free Market Consumer Group, this one from the Electronic Transactions Association, and this one from TechNet.

Mr. LOUDERMILK. [presiding]. Without objection.

Mr. HOLLINGSWORTH. Thank you. With that, I will yield back, Mr. Chairman.

Chairman LUETKEMEYER. The gentleman yields.

The Chair now recognizes the gentleman from Minnesota, the slapshot king of Alaska, Mr. Emmer, for 5 minutes.

Mr. EMMER. Thank you is in order, Mr. Chair. Thank you for letting me participate today. Thank you for the esteemed panel that we have on what I consider an amazing topic.

Despite the way I look, my youthful looks, I know all about this cryptocurrency stuff. But it has been an area that I have been very interested in since I got here.

To the panel, as you may have seen, the Chairman of the SEC and the CFTC recently co-authored an op-ed in the Wall Street

Journal where the concept of a more direct regulatory approach toward financial technology was discussed.

They said that quote, “Cryptocurrencies lack a fundamental characteristic of traditional currencies,” closed quote, and quote, “other hallmarks, such as governance standards, accountability and oversight, and regular and reliable reporting of trading and related financial data,” close quote.

That is what makes it go. You are here because—I also read in that article that the problem is typical currencies have the backing of a sovereign.

People are in this space. They started in this space because they were looking to get away from that. There is an argument about the way different governments handle their currency, and they wanted more freedom.

The question, I will start with Mr. Peters. In many ways, it seems like the potential for blockchain technology, virtual currency, and other fintech advances, runs parallel to the early days of the Internet, which benefited from a light touch or hands-off approach to regulation. Do you agree with this statement?

Mr. PETERS. I agree that there are many similarities to the early days of the Internet in the way you understand the underlying technology. With respect to policy, my organization does not have a particular position on it.

Mr. EMMER. Well, let me ask this. I will follow up with you. What are your thoughts on additional regulation in this space? We talked about it generally.

Everybody assumes we have banks, we have this, we have that, so this should be regulated. But I fear that the second you start doing this, you are going to suffocate what is an incredibly fertile ground.

To the people who say there is tremendous risk when investing in new technologies, to Professor Levitin. There is always risk. That is with the greatest risk comes the greatest reward.

There is this thing called buyer beware. So I just ask, if that is what we are talking about, where is that regulatory balance? And should there be?

Yes, Mr. Peters?

Mr. PETERS. For us, we are focused on the digital wallets that we already have in the marketplace. In many ways, the challenge from a regulatory perspective is one of scope and operational efficiency in terms of how you bring a service to market.

Without any specific position on blockchain or cryptocurrency, our existing laws based on U.S. currency are focused on that regulatory impediment.

Mr. EMMER. That is the problem. Now we are going to try and make cryptocurrency follow along as though it is U.S. currency.

Mr. Knight, maybe you can answer the same question?

Mr. KNIGHT. Sure. We need to keep in mind that the early Internet is a good parallel. The early Internet was regulated with a light touch.

There were, however, still regulations for things like fraud. If I defrauded you over the Internet, I still went to jail. Because you need certain regulations to enable a market, otherwise people won't come.

One thing I do think we need to be looking at in this space, particularly with regards to things like the securities laws is, are there areas where the technology allows us to address a risk that we are currently looking to regulation to address? And then if so, roll back that regulation so that duplicative regulation is no longer necessary.

That is not to say that there aren't significant challenges that we are seeing right now, and the SEC has shown admirable restraint in the ICO space.

But at a certain point, if you are committing securities fraud, you have to be held accountable or else the securities market could seize up.

The CFTC and the SEC have done a reasonably good job of trying to target legitimate bad actors and take them out, as they should, while working with just the hapless and ignorant and helping them get back into compliance and unwind their offerings.

Mr. EMMER. Well, one thing I want to point out before my time runs out, and I guess in a way ask Mr. Hoopes, you were talking about how your members can actually—the algorithms, the way that they can qualify people for different loans and the discrimination piece is gone.

Is it fair to say that your members can actually get more information and more reliable information using algorithms on information that is already available on the Internet?

Mr. HOOPES. That is correct.

Mr. EMMER. So isn't that going to solve a whole bunch of problems going forward? Don't we have to worry about overregulating in this space?

Mr. HOOPES. Yes, I do worry about overregulation. You also have to realize financial services is a very regulated framework. All of our members work really hard to ensure that as they do new things, they remain in compliance with all existing law.

Mr. EMMER. Well, I appreciate it.

Mr. Chairman, thank you for your patience. Thank you for letting me go here right at the end. I could continue this for a long time, but will be done for today. Thank you.

Mr. LOUDERMILK. [presiding]. The gentleman's time has expired. I would like to thank our witnesses for their testimony today. This is an important area we will be hearing more and more about, and hopefully we will be more engaged in this.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

[Whereupon, at 12:03 p.m., the subcommittee was adjourned.]

# **A P P E N D I X**

January 30, 2018



## MARKETPLACE LENDING ASSOCIATION

### TESTIMONY OF NATHANIEL L. HOOPES

#### EXECUTIVE DIRECTOR, MARKETPLACE LENDING ASSOCIATION

On behalf of the Marketplace Lending Association (MLA), thank you Chairman Luetkemeyer and Ranking Member Clay for the opportunity to testify before the House Financial Services Subcommittee on Financial Institutions and Consumer Credit.

The MLA represents the marketplace lending industry, and our goal is to promote a transparent, efficient, and customer-friendly financial system by supporting the responsible growth of marketplace lending, fostering innovation in financial technology (fintech), and encouraging sound public policy. MLA limits its membership to marketplace lending platforms (MPPs) that meet specific standards of safety and responsibility toward consumers and the overall marketplace. To that end, MLA members must (i) be transparent with consumers about APR / annualized interest rates, penalties, and fees, by disclosing them up front and in plain English; (ii) not offer so-called “payday” or “high-cost installment loans” that are above the 36% APR threshold set by the FDIC; and (iii) adhere, in facilitating loans to small businesses, to the Responsible Business Lending Coalition’s Small Business Borrowers’ Bill of Rights or to an equivalent self regulatory standard.<sup>1</sup>

As the Chairman and Ranking Member know, fintech – and marketplace lending in particular – is no longer just an idea or a possibility, it is now a proven solution to a long-standing problem – the lack of access to a wide range of affordable credit options for tens of millions of working Americans, recent graduates, and millions of small businesses. This industry is effectively serving the broad American “middle class” that remains our engine for economic growth and prosperity. It is also bringing greater democracy to investment in credit – providing investment opportunities once only available to the wealthiest or largest institutional investors in society. MPPs are delivering new, beneficial products to consumers, in locations that many banks no longer can serve; and increasing needed competition in key markets.

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<sup>1</sup> See <http://www.borrowersbillofrights.org>

However, much work still needs to be done for more of the American “middle class” to fully realize and benefit from the potential of MPPs specifically and fintech more broadly. This Subcommittee and the full Committee can build on its previous work to make that happen with the following:

- **Awareness:** Hearings like this one are pivotal to making more Americans aware of the financial services MPPs have to offer. MLA strongly encourages this Subcommittee to hold more hearings and for members to meet with small businesses and consumers in their districts who are taking advantage of the new products on the market today. In certain products – such as student loan refinancing – MPP borrowers can save more than \$20,000 dollars via lower interest costs.<sup>2</sup> Yet according to a recent report by the Federal Reserve of Boston, only 25% of consumers “have heard of marketplace lending or recognize any of the names of the largest marketplace lenders.”<sup>3</sup> As that percentage increases – with this Subcommittee’s help – the benefits off MPPs will become more well-known and the impact of the innovating services of MLA’s membership will drive economic growth even more.
- **Reaching the Underserved:** MPPs are reaching communities that have traditionally been unbanked and underbanked. We encourage this Subcommittee to continue to explore how MPPs are accomplishing that in a responsible way to help millions of Americans secure a better financial future for themselves, for their families, and for the small businesses that create long term wealth. To that end, MLA would like to thank Rep. Emanuel Cleaver (D-MO-5), a member of the full Committee, for his thoughtful investigation of “Small Business Fintech” lending. Among Rep. Cleaver’s findings was the conclusion that “Fintech loans are more likely to be used by minority-owned businesses.”
- **Opportunities for Congress:** There are a series of bipartisan bills that MLA encourages Congress to take up and pass as soon as possible, including the Protecting Consumers’ Access to Credit Act of 2017 and the IRS Data Verification Modernization Act of 2017. In addition, Congress, led by this Committee, should encourage the revitalization of FDIC-

<sup>2</sup> <https://commonbond.co/refinance-student-loan>

<sup>3</sup> <https://www.bostonfed.org/publications/current-policy-perspectives/2017/us-consumers-awareness-and-use-of-marketplace-lending.aspx>

supervised industrial loan companies (ILC), support the Special Purpose National Bank (SPNB) charter now under consideration by the OCC, reaffirm the powers of banks to build responsible third-party partnerships.

### **What are Marketplace Loans?**

The groundbreaking development and use of technology and data by MLA members makes it possible to interact with consumers on their terms, whether it is through a mobile device or on a computer, and make much faster underwriting decisions that are responsible and dependable. The innovative financial products delivered over that technology are helping millions pay off expensive credit card debt at lower rates, manage family emergencies, refinance student loan balances, save on interest when making necessary large purchases, and support small businesses.

The advanced technology that enables these products benefits both consumers and small business. Faster underwriting and adaption to mobile tailored to meet customer needs. In fact, a recent survey conducted by MLA with our industry partners confirmed that marketplace lending is working for small businesses. 95% of businesses surveyed that secured a loan online say it enabled or drove business growth – the capital made it possible to expand the number of locations, purchase new equipment, and manage cash flow. 98% of those borrowers said they would take out another loan from a marketplace lender and 70% said they have more lending options than they did just 5 years ago.<sup>4</sup> It is clear that new online options are helping address the small business credit gap that has persistently plagued our economy.<sup>5</sup>

In consumer fintech lending, two of the biggest misconceptions of the industry – perhaps developed back in the very earliest days of online lending – is that the loans are mostly short term loans that carry high rates. A second myth is that they are lightly regulated. The marketplace loans that have been widely embraced by consumers nationwide are neither of those things. The fintech data tracking firm dv01 advises that more than one million unsecured marketplace personal loans were issued last year – with an average loan balance of approximately \$14,000 and a term

<sup>4</sup> <http://onlinesmallbusinesslending.org>

<sup>5</sup> <http://static1.squarespace.com/static/55ef54f0e4b099741343c590/t/5740396a7c65e42453c5a468/1463826794900/Bicameral+Briefing+on+the+Small+Business+Credit+Gap+FINAL.PDF>

of greater than 4 years – far from being a small dollar, short term loan. MPPs offering consumer loans do so at an average of 14.7% APR and 100% of the loans are below the 36% APR threshold.<sup>6</sup> Approximately \$25 billion in such loan volume currently outstanding. To address the second myth, these are well regulated loans, subject to all the same consumer lending standards as any other consumer loan, with significant oversight from a wide array of federal and state prudential and consumer protection regulators.

Online unsecured personal loans from marketplace lending platforms have become a critical alternative option for borrowers looking for an affordable transparent path out of higher cost (often credit card) debt. The growth of these unsecured fintech-driven personal loans has been propelled in large measure by consumers looking to avoid carrying revolving credit card debt at a high APR by using a personal installment loan to consolidate their existing revolving credit card debt into a fixed term loan; by consumers who want and need better choices. For the sake of a quick comparison, a review of all the credit card offers on bankrate.com reveals that APRs on such products consistently range from 14.75% - 27% APR. With more than \$1.023 trillion in credit card debt now outstanding, many borrowers need lower APR options to refinance and pay down their consumer debt.<sup>7</sup> This has yielded billions in savings for borrowers. LendingClub alone estimates that it has provided borrowers with over \$2.4 billion in savings from lower interest rates.

#### **Reaching the Underserved**

To sum up another challenge that many MLA firms are working so hard to solve: the vast majority of American consumers reliably pay their debt obligations, yet less than half of Americans consistently qualify for prime credit. We believe we are making progress on this problem. Late last year the CFPB awarded the first ever no-action letter to Upstart Network, an MLA member company that uses alternative credit data and modeling in credit decisions.<sup>8</sup> And six months ago, the Federal Reserve of Philadelphia released a report that relied on data from Lending Club, one of the largest MPPs, and concluded in part that “lending activities by [F]intech lenders seem to have filled the credit gap”; and that the use of alternative data “has enhanced financial inclusion and allowed some borrowers to be assigned better loan

<sup>6</sup> <https://www.dv01.co>

<sup>7</sup> <https://www.americanbanker.com/news/credit-card-debt-hits-all-time-high-of-1023-trillion-fed>

<sup>8</sup> <https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/>

ratings and receive lower priced credit.”<sup>9</sup> LendingClub has also reported that it had 5x the representation of loans to minority owned businesses, and 4x the representation of women-owned businesses, compared to traditional bank conventional business lending.<sup>10</sup>

As the Philadelphia Fed study highlights, marketplace lending is well-positioned to help address the problem of access to responsible credit for several reasons. First, loan decisions by marketplace lenders are typically based on a more comprehensive picture of a potential borrower’s credit profile than just a FICO score which has not proven particularly predictive. As a result, marketplace lenders are able to offer more affordable financial products to a population of borrowers who are often not being offered choices by traditional brick and mortar banks. Second, marketplace lending platforms are also able to make decisions much faster than traditional lenders and do so with much greater transparency and ease for the borrower.

#### **Opportunities for Washington**

Success to date has been accomplished in spite of a federal and state legal and regulatory framework that was designed for a 19<sup>th</sup> and early 20<sup>th</sup> century banking system. Imagine what could be possible if that legal and regulatory framework was updated for the 21<sup>st</sup> century with its dramatically changed technologies, opportunities and needs. What is needed is a framework and system that supports, rather than hinders, the development of MPPs and other fintech companies, one that encourages these companies to develop innovative consumer friendly financial products that better meet the needs of all Americans.

That is the opportunity for Congress, led by this Subcommittee, and state regulators across the country – to better support innovation, start-ups and small businesses, new jobs and, most importantly, consumers. Creating a better environment for desirable growth is underpinned by two important objectives. First,

<sup>9</sup> <https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2017/wp17-17.pdf?la=en>

<sup>10</sup> Comparison based on % of lending, by dollar amount, drawing on BISG analysis of LendingClub business loans 2014-2017. Benchmarked to bank data in Senate Committee on Small Business and Entrepreneurship, “21st Century Barriers to Women’s Entrepreneurship,” July 23, 2014, and Temkin, Kenneth et al, “Competitive and Special Competitive Opportunity Gap Analysis of the 7(a) and 504 Programs,” Urban Institute. January 2008.

consumers benefit from greater product and service availability when those products are responsible products. Second, increased competition serves consumers and the economy – and so all market participants – traditional banks and the latest FinTech firms – should be encouraged to innovate and promote transparent, efficient, and customer friendly financial products. As internet access becomes widespread, especially within unbanked and underbanked communities, there is opportunity to secure access to financial products offered at APRs that are orders-of-magnitude lower than storefront payday loans, rent-to-own products, pawn shops, or other high-cost options.<sup>11</sup> Increased availability of products in underserved urban and rural markets helps to address a reduction in “brick and mortar” bank branches.

However, to fully realize the potential of those efforts, action by Congress is needed. This includes passing the *Protecting Consumers’ Access to Credit Act of 2017* (HR 3299), the *IRS Data Verification Modernization Act of 2017*, supporting the Office of Comptroller of the Currency’s (OCC) efforts to create a Special Purpose National Bank Charter (SPNB) for qualified fintech firms, reaffirming powers of banks to build responsible third-party partnerships, and the revitalization of FDIC supervised industrial loan company (ILC) charters. MLA strongly supports the efforts of the FDIC and the OCC to facilitate the interstate activities of state and national banks that work with MPPs and was very encouraged by the comments last week of the FDIC Chair nominee, who suggested that under her tenure, the FDIC would make decisions on ILC applications that are submitted. Experience has shown that ILCs are well-regulated banks with a clear purpose for our financial system.<sup>12</sup>

#### **Protecting Consumers’ Access to Credit Act of 2017**

In November of last year, the House Financial Services Committee reported out the *Protecting Consumers’ Access to Credit Act of 2017*, a bill sponsored by Rep. Patrick McHenry (R-NC-10), Rep. Trey Hollingsworth (R-IN-9), Rep. Gregory Meeks (D-NY-5), and Rep. Gwen Moore (D-WI-4). The bill would address the 2015 decision by the U.S. Court of Appeals for the Second Circuit in *Madden v. Midland Funding, LLC* that ignored a well-established principle of banking law – the “valid-when-made doctrine” – that a loan whose interest complies with applicable state law at the time of origination remains valid when sold, transferred, or assigned to third-parties.

The valid-when-made doctrine is critical to a healthy financial system, small

<sup>11</sup> <https://ag.ny.gov/consumer-frauds/rent-own>

<sup>12</sup> <https://www.americanbanker.com/opinion/six-myths-about-ilcs-corrected>

businesses, and consumers because it ensures liquidity in the credit markets, thereby reducing the cost of credit to borrowers. Both the OCC and President Obama's Solicitor General are on record as opposing the *Madden* decision, suggesting that the decision rests on a misunderstanding of Section 85 of the National Bank Act and existing Supreme Court precedent.<sup>13</sup>

Unfortunately, the Second Circuit's unprecedented decision in *Madden* created uncertainty and illiquidity in the credit markets, negatively impairing the availability and price of credit to consumers and small businesses in the three states that comprise the Second Circuit – New York, Connecticut, and Vermont. Specifically, the decision has frustrated a bank's ability to sell, assign, or transfer credit receivables (except to other banks) in the three impacted states, which then reduces the liquidity and value of those assets. This reduction in liquidity and asset value leads lenders to charge borrowers higher rates to compensate for the reduced liquidity and value of the loan assets. A recent study from researchers from Columbia, Fordham, and Stanford showed a post-*Madden* 52% decline in credit availability for borrowers in those 2<sup>nd</sup> Circuit states with credit scores under 625.<sup>14</sup>

The importance of passing the *Protecting Consumers' Access to Credit Act of 2017*, therefore is well known to this Subcommittee and the full Committee, which approved the bill by an overwhelming vote of 42-17. As Rep. McHenry said when he introduced the bill, "By codifying long-standing legal precedent with the valid-when-made doctrine, we ensure that low and middle-income Americans can access our financial markets. But this bill does more than promote financial inclusion, it also increases stability in our capital markets which have been upended by the Second Circuit's unprecedented interpretation of our banking laws."

Some have suggested that further amendment to this legislation may be needed to ensure that the legislation does not lead to any unintended consequences or predatory payday lending. It is relevant to point out here that the Center for Responsible Lending has highlighted in a written report that strong guidance from federal bank regulators has to-date been "generally successful" at stopping the emergence of bank-payday lending partnerships.<sup>15</sup> Today, this guidance from both the

<sup>13</sup> <https://www.lexology.com/library/detail.aspx?g=756adff1-6026-4037-8c66-9e1cb60f1fed>  
<https://supreme.justia.com/cases/federal/us/32/103/case.html>

<sup>14</sup> [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2780215](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2780215)

<sup>15</sup> <http://www.responsiblelending.org/state-of-lending/reports/10-Payday-Loans.pdf>

FDIC and OCC remains on the books, and it has been seen by market participants and issue experts as effectively banning all banks from partnering with so-called payday lenders.<sup>16</sup> The MLA therefore remains encouraged that the House will move this bipartisan bill, which has also been introduced in the Senate by Sen. Mark Warner (D-VA), Sen. Gary Peters (D-MI), Sen. Steve Daines (R-MT), and Sen. Pat Toomey (R-PA).

#### **IRS Data Verification Modernization Act of 2017**

Marketplace lenders offer innovative financial products to underserved consumers because of the use of data points beyond FICO scores and the speed by which lending decisions are made. One simple IT upgrade at the IRS would help marketplace lenders serve customers even better.<sup>17</sup> The *IRS Data Verification Modernization Act of 2017*, which was introduced in the House by Rep. McHenry, Rep. Earl Blumenauer (D-OR-3) and Rep. Nydia Velazquez (D-NY-7) and in the Senate by Sen. Cory Booker (D-NJ) and Sen. Mike Crapo (R-ID), would implement an application programming interface (API) at the IRS to replace the cumbersome, manual process required today where borrowers file what's called a 4506-T form giving the IRS permission to send summarized transcripts of a borrower's tax returns to a lender or another third-party.

Lenders then use those transcripts to confirm the details of a loan application. However, unless the borrower pays additional fees to expedite the process, which many small businesses and low-to-middle income consumers are not able to do, the process can take weeks, which is often too late to impact a loan decision. With an API, which is essentially a specification that allows one program to request data from another one securely and in real-time, replacing the 4506-T form process would lead to significant benefits for borrowers, including securing a better rate because the lender has a more complete picture of the borrower's credit history. Over time, this simple technological fix could lower risk in originated portfolios, allowing for improved loan pricing and even a less risky financial system as it becomes possible for lenders to easily and cheaply verify loan applications with

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<sup>16</sup> <https://www.occ.gov/static/news-issuances/memos-advisory-letters/2000/advisory-letter-2000-10.pdf>

<sup>17</sup> <https://techcrunch.com/2017/12/30/how-a-simple-tech-upgrade-at-the-irs-could-transform-the-economy/>

API-enabled tax data. It would also significantly speed up the disbursement of credit to consumers and businesses in real-time, allowing them to better plan expenditures and investment decisions. Automating the costly manual processing of 4506-T forms at the IRS could also improve the IRS' own operating efficiencies and reduce costs. We welcome the news that a legislative hearing will be held soon on this issue in the Ways and Means Committee.

#### **OCC Special Purpose National Bank and ILC Charters**

MLA strongly encourages members of this committee to support the SPNB charter that is currently under consideration by the OCC as well as the ILC Charter. A SPNB charter proposal was first introduced by the OCC under the leadership of former Comptroller Thomas Curry in 2016 and has since received support from the new Comptroller of the Currency, Joseph Otting.

The 50 states continue to play a vital role in setting standards and policing bad practices inside their borders, but forcing marketplace lenders to obtain and maintain licenses in each and every state frustrates innovation and imposes a fractured and inconsistent legal and regulatory regimen on national platforms serving customers over the internet. Meanwhile, incumbent national institutions bypass those state rules while not necessarily delivering credit products that best meet the current and future needs of underserved urban and rural communities.

That is why, in addition to reducing uncertainty by supporting the valid-when-made legislation, the MLA strongly encourages this Committee to support giving marketplace lenders at least the option to apply for a national bank charter. The proposal under consideration by the OCC strikes the right balance of promoting greater innovation but doing so within the constructs of existing national bank laws and regulations. As with previous generations of innovative products, like credit cards, the OCC proposal recognizes what this Committee knows so well – that the business of banking is not static – and the agency is working within its existing authority to create a single national regulatory option for financial technology firms.

The promise of a SPNB charter is a crucial first step that can ultimately yield immense benefits for consumers and businesses, especially for those located in a so-called “capital desert” where affordable credit options are scarce. Those potential borrowers can use the internet to gain access to the best products available to meet their needs. It is important to remember that the OCC proposed SPNB charter will simply be an option for national online lending platforms as an alternative to

partnering with an existing bank or obtaining and maintaining licenses in all 50 states, which in turn could impose outdated and arbitrary restrictions that are likely not even applicable to platforms that facilitate products exclusively on the internet. Still, the MLA is encouraged by preliminary steps that state regulators – led by the Conference of State Bank Supervisors (CSBS) – have taken to start making it easier for responsible, internet based direct lending platforms to operate and comply with laws and regulations in multiple states. The fact that CSBS is making this effort is an acknowledgment that there are serious pro-innovation and pro-consumer reforms that need to be made to the state framework; however, we believe, that this effort will be a long and challenging process and that Congress should also encourage the OCC and FDIC to move forward with the SPNB and ILC charter options quickly. To that end, MLA is strongly encouraged by the FDIC Chair nominee’s stated goal of simplifying the ILC chartering process where possible.

Ultimately, we believe that our financial system will not reach full potential in terms of the products, services, and efficiencies it can provide for consumers and small businesses until there is a workable charter option and a much more harmonized state regulatory framework that addresses the needs of a 21<sup>st</sup> century market environment. Ensuring there is a charter option available that facilitates a nationwide footprint could help enable our U.S. banking regulatory framework to remain at the forefront of the technology and innovation that has been emerging domestically and abroad.

**Reaffirming powers of banks to build responsible third party partnerships**

Marketplace lending platforms today often work in partnership with banks to compete with traditional unsecured credit offerings – typically credit cards. In a properly structured partnership with a bank, borrowers benefit from the same regulatory protection and oversight as a direct bank customer. The issuing bank partnership structure involves rigorous and ongoing monitoring of a fintech platform by the fintech platform’s internal compliance staff, the bank, and the bank’s regulator. This includes regular compliance testing, third party audits, and ongoing compliance training. These partnerships also bring FinTech platforms under the authority of the FDIC under the Bank Service Company Act.

Further, far from discouraging partnerships, the FDIC has issued proposed supplemental guidance, provided in Financial Institution Letter 50 (FIL 50), that applies to all FDIC-supervised institutions that engage in third-party lending.<sup>18</sup> It

<sup>18</sup> <https://www.fdic.gov/news/news/financial/2016/fil16050b.pdf>

recognizes a number of different lending partnerships: “Institutions originating loans for third parties; institutions originating loans through third parties or jointly with third parties; and institutions originating loans using platforms developed by third parties.” The proposed guidance emphasizes that institutions should take a number of steps to manage these relationships, including:

- Establishing a “third-party lending risk management program and compliance management system (CMS) that is commensurate with the significance, complexity, risk profile, transaction volume, and number of third-party lending relationships. Consistent with existing guidance, the risk management program and CMS should address risk assessment, due diligence and oversight, and contract structuring when selecting and managing individual third-party lending relationships.”
- “For institutions that engage in significant lending activities through third parties, the proposal includes increased supervisory attention, including a 12-month examination cycle, concurrent risk management and consumer protection examinations, offsite monitoring, and possible review of third parties.”

The key point is that the FDIC has, with FIL 50 and elsewhere, recognized that marketplace lending platforms that operate as a service provider to an issuing bank partner can provide significant benefits to borrowers by offering responsible and innovative credit products, within a strong regulatory framework. There appears to be little doubt where the FDIC stands on this issue, and I would urge the committee to take a close look at the FDIC’s work and similarly find ways to encourage bank partnerships as you contemplate further legislative action. The MLA also acknowledges and appreciates the recent legislative work by Chairman Luetkemeyer to help clarify the power of FDIC supervised banks to partner with third-party service providers pursuant to Section 521 of the Depository Institutions Deregulation Act of 1980 (DIDA). A reaffirmation of those powers could create market certainty that is currently lacking as a result of sporadic, wildly inconsistent and at times ill-conceived judicial decisions.

### **Conclusion**

To conclude, there are numerous other ways that Congress and this committee can promote both competition and innovation in financial services. For example, the MLA encourages this Committee to take a leadership role in promoting and

preserving the rights of consumers to access and grant permission to their banking and other transaction information safely and securely. Doing so will foster competition and innovation and will empower more Americans to benefit from financial technology. Unfortunately, certain financial institutions have at times attempted to restrict consumers' control and use of their own financial data. The law of the United States, however, is clear: consumers should be in control of their own financial information. Policymakers should consider ways to support reforms to the definition of an 'accredited investor' so that all investors with an understanding of financial markets have access to the full range of investment opportunities. Finally, efforts to bring greater high speed internet penetration to our underserved communities are crucial to ensure that fintech options are truly available to everyone, and we urge policymakers to continue to take steps towards that goal.

Our hope is that lawmakers will ensure that innovation and competition continues to be welcome in our banking regulatory system by modernizing and clarifying laws where appropriate, and supporting multiple avenues for responsible nationwide lending, including through a bank partner model, the availability of appropriate national charter options and a more harmonized state regulatory framework. That concludes my testimony.

Thank you for the opportunity to appear before you today.

## MODERNIZING REGULATION TO ENCOURAGE FINTECH INNOVATION

**Brian Knight**

*Director, Program on Financial Regulation, Mercatus Center at George Mason University*

House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit  
 Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace

January 30, 2018

Good morning, Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee. Thank you for inviting me to testify.

My name is Brian Knight, and I am the director of the Program on Financial Regulation and a senior research fellow at the Mercatus Center at George Mason University. My research primarily focuses on the role of technological innovation in financial services. Any opinions I express today are my own and do not necessarily reflect the views of my employer.

First, let me thank Chairman Luetkemeyer and Ranking Member Clay for your leadership in holding a hearing on the promise and challenges of financial technology, or “fintech,” and how the legal and regulatory environment should adapt in response. I also appreciate your efforts to have representatives from a broad array of positions and viewpoints engage in a collegial and respectful discussion. It is an honor to be asked to testify.

Defined most broadly, fintech is simply the application of technology to the provision of financial services, and it is therefore ubiquitous and constant. However, we are seeing a unique period of innovation in financial services marked by the use of the internet (as a borderless delivery mechanism), lower barriers to entry, new competitors from outside the traditional financial services industry, and increasingly rapid innovation by firms and adoption of innovative technologies by customers.<sup>1</sup> These characteristics are placing pressure on the existing regulatory environment.

Given the potential breadth of the topic and the limited time available, I would like to focus my testimony on some of the issues facing nonbank financial firms and the role that Congress should play in supporting innovation, though I am happy to try to answer any questions you may have to the best of my ability.<sup>2</sup>

<sup>1</sup> For a thorough analysis of these and other characteristics of the current fintech movement, see *generally* CHRISTOPHER BRUMMER & DANIEL GORFINE, FINTECH: BUILDING A 21ST-CENTURY REGULATOR’S TOOLKIT (2014), <http://www.milkeninstitute.org/publications/view/665>.

<sup>2</sup> The breadth of the topic has also given rise to inconsistent use of terminology. For the purposes of this testimony, a firm identified as a “fintech” will be a nonbank; “virtual currency” will include cryptocurrencies like Bitcoin. I apologize in advance for any unintentional inconsistencies.

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*The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.*

Specifically, there are three ways Congress could help:

1. Clarifying existing regulation, including but not limited to issues around the validity of a loan made by a depository institution in conjunction with a fintech lender partner so that consumers can benefit from more efficient and competitive credit markets.
2. Modernizing regulation to eliminate unnecessary or unjustified barriers to competition from new firms, including but not limited to fintech lenders and money transmitters being subject to state-by-state licensing and limitations while their bank competitors enjoy broad uniformity granted by federal law.
3. Enabling regulators to provide the necessary and appropriate regulatory environment where companies can experiment with innovative services while ensuring appropriate consumer protection.

### THE POTENTIAL PROMISE OF FINTECH

Innovations in financial technology have the potential to significantly improve the quality of financial services available to Americans. For example, there is evidence that nonbank fintech lenders are able to fill in holes left by banks that have left communities and to offer some consumers credit at lower rates than would otherwise be available using traditional funding and credit scoring metrics or to consumers who otherwise would have trouble accessing credit.<sup>3</sup> This would explain why a significant portion of loans offered by fintech lenders are used by borrowers to consolidate existing debt.<sup>4</sup> There is also evidence that the use of algorithmic scoring may result in *less* discrimination than traditional underwriting. For example, researchers at the University of California, Berkeley, have found mortgage data indicating that fintech lenders who use algorithmic underwriting were significantly less likely to discriminate against African American and Hispanic borrowers than were traditional lenders.<sup>5</sup>

Likewise, in money transmission, nonbank technology-enabled firms are providing alternatives to traditional checks and wires, offering real-time and peer-to-peer payments.<sup>6</sup> This competition has prodded banks to improve their products, including the introduction of same-day ACH payments and the introduction of bank-sponsored peer-to-peer payments apps.<sup>7</sup> Fintech firms are also helping facilitate payments by employers, allowing employees to be paid on a daily basis rather than being paid every week or every two weeks.<sup>8</sup>

<sup>3</sup> See Usman Ahmed et al., *Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, 10 INNOVATIONS 35, 35-36 (2015) (finding PayPal Working Capital loans disproportionately disbursed to areas with relatively high declines in the number of banks and to traditionally underserved populations); JULAPA JAGTIANI & CATHARINE LEMIEUX, FINTECH LENDING: FINANCIAL INCLUSION, RISK PRICING, AND ALTERNATIVE INFORMATION, 19-22, 26 (Working Paper No. 17-17, Fed. Res. Bank of Phila., 2017), <https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2017/wp17-17.pdf>. See also YULIA DEMYANYK & DANIEL KOLLINER, PEER-TO-PEER LENDING IS POISED TO GROW (Fed. Res. Bank of Cleveland, Aug. 14, 2014), <https://www.clevelandfed.org/newsroom-and-events/publications/economic-trends/2014-economic-trends/et-20140814-peer-to-peer-lending-is-poised-to-grow.aspx>; U.S. DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING, 21 (2016) [hereinafter TREASURY REPORT], [https://www.treasury.gov/connect/blog/Documents/Oportunities\\_and\\_Challenges\\_in\\_Online\\_Marketplace\\_Lending\\_white\\_paper.pdf](https://www.treasury.gov/connect/blog/Documents/Oportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf).

<sup>4</sup> TREASURY REPORT, II.

<sup>5</sup> ROBERT P. BARTLETT, ADAIR MORSE, RICHARD STANTON & NANCY WALLACE, CONSUMER LENDING DISCRIMINATION IN THE FINTECH ERA, 18-22 (UC Berkeley Public Law Research Paper, Dec. 7, 2017), <https://ssrn.com/abstract=3063448>.

<sup>6</sup> See, e.g., Venmo (<https://venmo.com/>); Square (<https://squareup.com/>).

<sup>7</sup> Zelle is a real-time payments app (<https://www.zellepay.com/>) established by Early Warning Services, LLC, a company owned by Bank of America, BB&T, Capital One, JPMorgan Chase, PNC Bank, U.S. Bank, and Wells Fargo (<https://www.earlywarning.com/pdf/early-warning-corporate-overview.pdf>). The Zelle app facilitates transfers between bank accounts of partnering banks.

<sup>8</sup> Michael Corkery, *Walmart Will Let Its 1.4 Million Workers Take Their Pay Before Payday*, N.Y. TIMES, Dec. 13, 2017, <https://www.nytimes.com/2017/12/13/business/walmart-workers-pay-advances.html> (discussing Walmart's partnership with Even (<https://even.com/>) to facilitate same-day wage payments to Walmart employees).

Virtual currencies, the largest and most famous being Bitcoin, are also providing consumers with new means to conduct financial transactions. Virtual currencies are means to an end, rather than an end in themselves. For example, Bitcoin was designed to compete with government-backed currencies. However, the underlying technology of a distributed, modification-resistant ledger has been considered for a wide range of transactions outside of currency where the ability to maintain a common record of transactions is important.<sup>9</sup> Other virtual currencies have also developed seeking to more effectively facilitate actions ranging from international money transfer to corporate capital formation.

### THE CHALLENGES POSED

While fintech presents significant promise, it also presents certain challenges. For example, while Initial Coin Offerings (ICOs) may enable firms to access capital more effectively than traditional methods, there are significant concerns that they are being used by both outright frauds and well-meaning but ignorant firms to obtain capital in contravention of existing laws governing the sales of securities, commodities futures contracts, and products and services.

The considerable increase in value for numerous virtual currencies in the past year has given rise to fears that the prices reflect an asset bubble rather than the assets' true value and that the eye-popping prices attract scammers preying on the vulnerable.<sup>10</sup> Virtual currencies may also potentially present risks to both law enforcement and national security by allowing bad actors to move money illegally or avoid sanctions.<sup>11</sup> This risk, however, is not unique to virtual currencies—it exists with every means of value transmission, including cash.

In the lending context, there is a concern that fraudulent and unlicensed lenders, brokers, or lead generators will defraud borrowers. This concern is particularly acute in the online payday loan space and in small-business lending, where concerns about broker business practices have led to industry initiatives like the Small Business Borrowers' Bill of Rights.<sup>12</sup>

The firms providing fintech services also face challenges. For example, online lenders face a significant risk of being defrauded by borrowers because of the arms-length nature of and limits in knowledge inherent in the online model. Borrowers may use false identities to obtain credit they have no intent to repay, or they may apply for multiple loans from different lenders over a short period of time. This "stacking" prevents the lender from knowing about the borrower's other lines of credit until it is too late. While not every "loan stacker" intends to defraud lenders, the practice can prevent lenders from making fully informed lending decisions and increase the risk of default, leading to increased prices for other borrowers.<sup>13</sup>

<sup>9</sup> While the Bitcoin ledger is often called immutable, there is a dispute as to whether this is true. See, e.g., Angela Walch, *The Path of the Blockchain Lexicon (and the Law)*, 36 REVIEW OF BANKING AND FINANCIAL LAW 713, 735-745 (2017) (discussing whether Bitcoin's ledger is truly "immutable"); in the context of Bitcoin, this ledger is called the "blockchain." Other virtual currencies may use different means of maintaining a ledger with different characteristics in terms of distribution, mutability, and control mechanisms.

<sup>10</sup> See, e.g., Gabriel Rubin, *CFTC Alleges Fraud in Three Virtual-Currency Cases*, WALL STREET JOURNAL, Jan. 19, 2018, [https://www.wsj.com/amp/articles/cftc-alleges-fraud-in-three-virtual-currency-cases-1516338060?\\_\\_twitter\\_impression=true](https://www.wsj.com/amp/articles/cftc-alleges-fraud-in-three-virtual-currency-cases-1516338060?__twitter_impression=true); Sarah Buhr, *SEC's New Cyber Unit Takes Its First Action to Halt an Initial Coin Offering "Scam."* TECHCRUNCH, Dec. 4, 2017, <https://techcrunch.com/2017/12/04/secs-new-cyber-unit-takes-its-first-action-to-halt-an-initial-coin-offering-scam/>.

<sup>11</sup> See, e.g., Max Seddon & Martin Arnold, *Putin Considers "Virtualruble" as Moscow Seeks to Evade Sanctions*, FINANCIAL TIMES, Jan. 1, 2018, <https://www.ft.com/content/54d026d8-e4cc-11e7-97e2-916d4fbac0da>.

<sup>12</sup> Available at <http://www.borrowersbillofrights.org/>. This is not intended as an endorsement of the Small Business Borrowers' Bill of Rights or any other industry initiative.

<sup>13</sup> See, e.g., Penny Crosman, *How Fraudsters Are Gaming Online Lenders*, AMERICAN BANKER, Mar. 28, 2017, <https://www.americanbanker.com/news/how-fraudsters-are-gaming-online-lenders>.

### THE CHALLENGES POSED BY THE CURRENT REGULATORY ENVIRONMENT

Every example of fintech is highly regulated from the moment it is conceived of. In some cases, the existing regulatory environment harms innovation by forcing firms to comply with multiple, often inconsistent sets of rules, pay the costs of having to constantly monitor numerous state and federal regulators, and face the uncertainty of not knowing whether an activity is subject to regulation.

The ability of new fintech competitors who are able, from the very beginning, to serve customers nationwide, is hampered by state-by-state regulation that their bank competitors do not face.<sup>14</sup> If this discrepancy were justified, there would be no concern, but all too often it isn't. One clear example is the difference in treatment around lending licenses and the laws governing interest.

Under federal law, nationally chartered banks and federally insured state-chartered banks are able to lend nationwide on the basis of their charter and under their home state's laws governing interest.<sup>15</sup> This uniformity allows for legal certainty and product uniformity nationwide, as banks are able to lend to similarly situated borrowers at the same terms. Conversely, fintech lenders are primarily regulated at the state level and are required to obtain licenses from each state they wish to lend in, and they are subject to the laws governing interest of the borrower's home state.<sup>16</sup>

This difference in regulatory treatment makes it very hard for fintech lenders to compete directly with banks, since banks are simply able to operate in a more consistent and streamlined manner. This has encouraged fintech lenders to partner with banks. Partnering with a bank allows fintech lenders to offer a consistent product nationwide. It also allows the banks to access additional borrowers and make more loans than they would otherwise be able to. While the bank often sells off at least a significant portion of the loan to either an institutional buyer or the fintech lender, the bank frequently receives a fee tied to the performance of the loans and ultimately retains regulatory responsibility for the loans.<sup>17</sup> The fintech lender is also regulated under the Bank Service Company Act and is subject to examination by the bank's federal regulator for the lender's actions conducted pursuant to the partnership.<sup>18</sup> While partnerships driven by regulation can benefit fintech lenders, their bank partners, and the public, they are also a second-best solution.

Yet even this second-best solution of bank partnerships is under threat from recent litigation and regulatory actions. The most notable of these actions are the decision in *Madden v. Midland Funding* in the United States Court of Appeals for Second Circuit and Colorado's lawsuits against two marketplace lenders.<sup>19</sup> The result in *Madden* has called into question whether a bank could sell a loan that was valid when made by the bank to a nonbank, and have the loan remain valid if it was usurious under the borrower's state's law. While this case does not directly implicate fintech lenders, its seeming refutation of the principle that a loan valid when made remains valid even if sold implicates the bank partnership model.

<sup>14</sup> For a more thorough discussion of this topic, please see Brian Knight, *Federalism and Federalization on the Fintech Frontier*, 20 VAND. J. ENT. & TECH. L. 129 (2017), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2928985](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2928985).

<sup>15</sup> US DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES IN ONLINE MARKETPLACE LENDING, 6 (May 10, 2016); John L. Douglas, *New Wine into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INSTITUTE JOURNAL 1, 17, 34 (2016). See 12 U.S.C. § 85 (national banks); 12 U.S.C. § 1831d(a) (federally insured state-chartered banks); see also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978). Other financial institutions, including federal credit unions and savings associations, enjoy similar provisions. See, e.g., 12 U.S.C. § 1785(g)(1) (federal credit unions); 12 U.S.C. § 1463(g)(1) (savings associations).

<sup>16</sup> US DEP'T OF THE TREASURY, OPPORTUNITIES AND CHALLENGES, 5; Douglas, *New Wine into Old Bottles*, 31-32.

<sup>17</sup> E.g., Guidance for Managing Third-Party Risk, FIL-08-044 (Jun. 6, 2008) ("[T]he FDIC evaluates activities conducted through third-party relationships as though the activities were performed by the institution itself. In that regard, it must be noted that while an institution may properly seek to mitigate the risks of third-party relationships through the use of indemnity agreements with third parties, such agreements do not insulate the institution from its ultimate responsibility to conduct banking and related activities in a safe and sound manner and in compliance with law.").

<sup>18</sup> 12 U.S.C. § 1867(c).

<sup>19</sup> *Midland Funding, LLC v. Madden*, 786 F.3d 246 (2d Cir. 2015).

More directly relevant are the recent enforcement actions by Colorado against two marketplace lenders who made loans in Colorado in conjunction with bank partners. Colorado is seeking to hold that the marketplace lenders are the “true lender,” and that therefore the loans are governed by Colorado state law, despite the loans actually being made by two FDIC-insured state-chartered banks. Colorado does not dispute that if the loans are made by the banks, they are valid—rather, they argue that the banks lack a sufficient economic interest in the loans to qualify as the true lender. The banks have in turn sued Colorado, arguing that the state’s efforts impede their ability under federal law to make and sell loans.

The uncertainty surrounding the bank partnership model has reduced credit availability. For example, recent research has found that credit availability for borrowers with FICO scores below 700 from three large fintech lenders decreased significantly in New York and Connecticut compared to states outside the Second Circuit after the *Madden* decision.<sup>20</sup> Further, the uncertainty risks creating an absurd situation where the legality of a loan is not determined by the loan’s characteristics but by who ends up owning the loan, even though the borrower’s obligations do not change. It also privileges banks over competitors because banks are allowed to make and hold loans that nonbanks may not be allowed to.

Another area where state-by-state regulation risks impeding innovation is money transmission, both for firms that operate in dollars and those that use virtual currencies. While, generally speaking, banks are not required to obtain state money transmitter licenses,<sup>21</sup> nonbanks—including innovative fintech firms—are required to obtain a license in every state where they offer services.<sup>22</sup> While almost all states require licenses, the criteria of who is covered by the licensing regime and what is required for compliance vary among states, and obtaining licenses can be an expensive and time-consuming activity.

This problem is even more acute with firms that provide payments services via virtual currencies. Some states have held that virtual currency exchanges are covered under their existing money transmission laws; others have modified their laws or remained silent about the extent to which their existing rules govern virtual currency transactions.<sup>23</sup> New York is unique in creating a virtual-currency-specific regulatory regime with its BitLicense.<sup>24</sup> While the Uniform Law Commission has proposed a uniform law to regulate virtual currency transmitter businesses at the state level, this law has not yet been adopted by any state.<sup>25</sup>

Beyond questions of federalism, there are broader problems with the fragmentation of the current regulatory system. While this problem is not new,<sup>26</sup> the pace of innovation and adoption and the cross-cutting nature of fintech offerings exacerbate the problems created.

For example, outside of the money-transmission context there is confusion as to which regulators have authority over transactions involving virtual currencies. The use of digital tokens by firms to raise money may be considered a sale of securities, commodities, or the presale of a product, or some combination thereof. This confusion is the result of the law privileging substance over form in that the economic reality of the transaction, rather than the method, governs. While this approach is understandable, it can also create gray areas that Congress could clarify.

<sup>20</sup> Colleen Honigsberg, Robert J. Jackson & Richard Squire, *How Does Legal Enforceability Affect Consumer Lending? Evidence from a Natural Experiment*, JOURNAL OF LAW AND ECONOMICS (Aug. 2, 2017), available at <https://ssrn.com/abstract=2780215>.

<sup>21</sup> Kevin V. Tu, *Regulating the New Cashless World*, 1 ALABAMA LAW REVIEW 65, 77, 89 (2013).

<sup>22</sup> Tu, *Regulating the New Cashless World*, 86–89.

<sup>23</sup> See Coin Center State Regulation Tracker (<https://coincenter.org/page/state-digital-currency-regulatory-tracker>).

<sup>24</sup> N.Y. COMP. CODES R. & REGS. TIT. 23, §§ 200.1–200.22 (2017).

<sup>25</sup> NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM REGULATION OF VIRTUAL-CURRENCY BUSINESS ACT (2017), <http://www.uniformlaws.org/Act.aspx?title=Regulation%20of%20Virtual-Currency%20Businesses%20Act>.

<sup>26</sup> See GOVERNMENT ACCOUNTABILITY OFFICE, COMPLEX AND FRAGMENTED STRUCTURE COULD BE STREAMLINED TO IMPROVE EFFECTIVENESS (GAO-16-175, Mar. 28, 2016), available at <https://www.gao.gov/products/GAO-16-175>.

Overlapping regulatory jurisdictions may hamper any efforts by regulators to provide regulatory relief via a “regulatory sandbox” or other means.<sup>27</sup> Even if one regulator enters into an agreement with a company to allow the company to experiment in exchange for limited liability, this would not be binding on other regulators (potentially including state regulators), severely limiting the usefulness of the regulatory relief program. This problem would also apply in cases where a state wished to offer a regulatory sandbox because the company would still face potential federal enforcement and private liability.<sup>28</sup>

#### POSSIBLE IMPROVEMENTS

The current regulatory environment is not ideal, and Congress could improve it in several ways. First, while the power of a bank to make a loan and have it remain valid after it is sold exists under current law, clarification would be helpful to provide certainty. Congress could amend the relevant statutes to make explicit the right of a bank to make and sell a loan, and have the loan remain valid on its original terms.

Second, fintech firms should be able to operate on a nationwide basis without unduly burdensome state-by-state regulation. One option currently being considered by the Office of the Comptroller of the Currency (OCC) is to offer national-bank charters to nondepository lenders and money transmitters. This would allow those firms to tap into the existing powers of national banks. While this is a worthy idea, it is not and should not be the only solution. Instead, in addition to the OCC’s efforts, the states should be allowed to play a more active role in forwarding innovation.<sup>29</sup>

States are currently at a disadvantage in that, while it is arguably possible for national banks to be nondepositories and still be able to export their home state’s law governing interest, under federal law that power is limited to FDIC-insured state banks. Congress could change this requirement to allow states to offer new nondepository bank charters comparable to those considered by the OCC.

Congress could also allow nonbank, state-licensed lenders and money transmitters to operate on the basis of their home state license and law in a way comparable to the privileges banks enjoy under federal law. This would allow innovative nondepository firms to be able to compete on a national basis without forcing them into the banking system, and it would allow for state experimentation and competition.

Third, Congress should explore allowing state and federal regulators to establish regulatory sandboxes or other comparable regulatory relief programs for limited trials of innovative products. Congress could allow a firm that participates in such a program and complies with the program’s requirements to avoid liability beyond that established by the program, subject to minimum requirements including the firm making its customers whole if the firm causes harm owing to a violation of the law.

<sup>27</sup> While definitions of “regulatory sandbox” differ, they can generally be thought of as a program where a company or group of companies enters into an agreement with regulators that allows the company to try a new product or service on a limited set of customers under the observation of the regulator. This program could involve allowing firms to offer a service they would otherwise need a license for or providing some limitation to potential liability faced by the firm if the experimental product or service ends up violating the law, though a requirement that the firm make the customers whole is standard. The United Kingdom Financial Conduct Authority is credited with launching the first regulatory sandbox for fintech in 2015.

<sup>28</sup> For example, Arizona Attorney General Mark Brnovich and Arizona State Representative Jeff Weninger have introduced legislation (HB 2434) to create a regulatory sandbox for financial firms operating in Arizona (<https://www.azag.gov/press-release/ag-brnovich-works-rep-weninger-introduce-groundbreaking-regulatory-sandbox>).

<sup>29</sup> For a more thorough discussion of what this might look like, see generally J.W. VERRET, A DUAL NON-BANKING SYSTEM? OR A NON-DUAL NON-BANKING SYSTEM? CONSIDERING THE OCC’S PROPOSAL FOR A NON-BANK SPECIAL PURPOSE NATIONAL CHARTER FOR FINTECH COMPANIES, AGAINST AN ALTERNATIVE COMPETITIVE FEDERALISM SYSTEM, FOR AN ERA OF FINTECH BANKING (Geo. Mason Law & Econ. Research Paper No. 17-05, Jan. 26, 2017), <https://ssrn.com/abstract=2906329>; Knight, *Federalism and Federalization on the Fintech Frontier*, 20 VAND. J. ENT. & TECH. L. 129, 200-204 (2017).

Fintech presents significant potential to improve the quality and inclusiveness of financial services. The current regulatory environment risks hampering this development, but intelligent changes can be made to make regulation friendlier to innovation and competition while still protecting consumers.

Thank you again for the opportunity to testify. I look forward to your questions.

**ATTACHMENTS (4)**

Modernizing Financial Technology Regulations to Facilitate a National Market (Mercatus on Policy)

Risks to Innovative Credit Posed by Emerging Regulatory and Litigation Trends (Mercatus on Policy)

Brian Knight, "Innovation Will Stall without a Regulatory Fintech Sandbox," *American Banker*,

November 15, 2016.

Brian Knight, "Credit Markets Need Legislative Guidance after Madden Decision," *American Banker*,

September 14, 2017.

# MERCATUS ON POLICY

## Modernizing Financial Technology Regulations to Facilitate a National Market

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July 2017



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### CURRENT TECHNOLOGY ALLOWS NONBANK

financial service providers to compete on a national scale with banks more effectively in areas including lending and money transmission.<sup>1</sup> While these firms may be able to offer services at lower cost<sup>2</sup> and lower risk<sup>3</sup> while improving access to underserved customers,<sup>4</sup> they also face challenges from the existing regulatory structure. If these challenges are not successfully addressed, they risk denying consumers the benefits of innovation and competition that financial technology (fintech) can provide.

The inadequacy of the existing regulatory structure is particularly evident in the allocation of regulatory responsibility between the states and the federal government. Banks frequently are subject, via federal law and state comity, to relatively uniform legal rules in important areas like licensing<sup>5</sup> and the laws governing interest on a loan.<sup>6</sup> Conversely, nonbank fintech firms providing lending or money transmission services are generally subject to inconsistent state-by-state regulation.<sup>7</sup> Nonbank fintech providers thus operate at a disadvantage compared with banks, and the unequal treatment of banks and nonbank firms causes both inefficiency and inequity in the financial marketplace. Table 1 illustrates the differences in regulatory treatment for certain issues between national banks, state banks, and nonbank financial institutions.

### PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

The choice between federalization and state regulation is a continuum, not a binary decision. Banks, despite the uniformity owing to federal preemption that they enjoy in many areas, are still subject to significant state regulation in certain cases. The current regime of burdensome state regulation for nonbank

Table 1. Select Regulatory Differences between Banks and Nonbanks			
REGULATORY BARRIER	NATIONAL BANK	INSURED STATE BANK	NONBANK FINANCIAL INSTITUTION
Laws governing interest on loans	exportation of home state law <sup>a</sup>	exportation of home state law <sup>b</sup>	law of borrower's state applies <sup>c</sup>
State lender licensing	exempt <sup>d</sup>	generally exempt <sup>e</sup>	state license required <sup>f</sup>
Money transmission licensing	exempt <sup>g</sup>	generally exempt <sup>h</sup>	state license required <sup>i</sup>

Notes:<sup>a</sup>National Bank Act, 12 U.S.C. § 85 (2015); see also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978); 12 C.F.R. § 7.4001(a)(1997) (allowing banks to use their home state's definition of what constitutes interest nationwide); *Smiley v. Citibank (S.D.)*, N.A., 517 U.S. 735 (1996) (upholding same).

<sup>b</sup>The Depository Institutions Deregulation Act of 1980 (12 U.S.C. § 1831d(a) (2015)) (granting the same power to state-chartered, federally insured banks); FDIC, General Counsel's Opinion No. 10: Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998) citing 12 C.F.R. § 7.4001(a) (1997) and 12 C.F.R. § 560.110(a)(1997) (allowing banks to use their home state's definition of what constitutes interest nationwide); *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992) ("The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act in pari materia. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way").

<sup>c</sup>John L. Douglas, "New Wine into Old Bottles: Fintech Meets the Bank Regulatory World," North Carolina Banking Institute Journal 20, no. 1 (2016): 17, 31-32; letter from Manuel P. Alvarez, chief compliance officer for Affirm, Inc., to US Treasury, September 30, 2015, 7; letter from Sam Hodges, managing director for Funding Circle, and Conor French, general counsel, to US Treasury, September 30, 2015, 27; letter from Mitria Wilson for Oportun to US Treasury, September 30, 2015, 11-14; letter from Robert Lavet, chief legal officer for Social Finance, Inc., to US Treasury, September 30, 2015, 3-5.

<sup>d</sup>US Department of the Treasury, Opportunities and Challenges in Online Marketplace Lending, May 10, 2016, 6; Douglas, "New Wine into Old Bottles," 34.

<sup>e</sup>Department of the Treasury, Opportunities and Challenges, 6; Douglas, "New Wine into Old Bottles," 34.

<sup>f</sup>Department of the Treasury, Opportunities and Challenges, 5; Douglas, "New Wine into Old Bottles," 32.

<sup>g</sup>Kevin V. Tu, "Regulating the New Cashless World," Alabama Law Review 65, no. 1 (2013): 77, 89. See also Bryan Cave LLP, "The Latest in Money Transmitter Licensing," February, 19, 2015, slide 20.

<sup>h</sup>Tu, "Regulating the New Cashless World," 89; Bryan Cave LLP, "The Latest in Money Transmitter Licensing."

<sup>i</sup>Tu, "Regulating the New Cashless World," 86-89.

fintech firms creates three separate but interrelated problems: (1) it harms consumers by forcing fintech firms into an inefficient regulatory environment; (2) it damages competitive equity by differently regulating firms that offer similar services; and (3) it risks violating political equity among citizens of different states because some states de facto regulate the national market. Fortunately, there are ways to address these problems, which will be discussed below.

#### Inefficiency

Being forced to obtain licenses from each state in which a nonbank firm wishes to do business can be costly and time consuming.<sup>8</sup> In addition to the cost and delay of obtaining licenses, different states impose different substantive requirements regarding licensing<sup>9</sup> and what products or services licensed firms can provide.<sup>10</sup> This inconsistency can also impose significant ongoing "search costs" on firms as they need to constantly monitor each state for

changes in the law.<sup>11</sup> This inefficiency can make it hard for firms to offer products, which has led many firms, especially in the lending space, to partner with banks to take advantage of the banks' federally granted preemption.<sup>12</sup>

The bank-partnership model addresses the inefficiencies of state-by-state regulation, but it does so at a cost. The direct costs include the banks' compensation for their participation and the added complexity required to structure the transaction. But there are also indirect costs, including uncertainty about enforceability, which has been exacerbated by recent litigation and state regulatory action.

These actions include the recent *Madden v. Midland Funding, LLC* decision,<sup>13</sup> in which the United States Court of Appeals for the Second Circuit held that a loan originally valid when made by a bank could subsequently become usurious and invalid once sold to a nonbank. While this decision does not directly involve innovative nonbank lenders, it does strike at

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**While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help.**

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the heart of the bank-partnership model, which relies on banks selling loans to nonbanks for servicing.

The *Madden* court's reasoning has affected the nonbank lending market. Loan volume for borrowers with relatively low credit scores seeking to use innovative lenders has declined significantly in 2016 relative to 2015 in the areas covered by the Second Circuit, while it has increased outside the Second Circuit.<sup>14</sup> Additionally, other parties have adopted the reasoning of *Madden* to directly attack the bank-partnership model, arguing that even if a loan is valid when made by a bank, it can become invalid when sold to a nonbank firm. For example, Colorado's Uniform Consumer Credit Code administrator has sued two marketplace lenders alleging that the loans made by their bank partners were invalid, in part based on the claim that once the loans were sold to the nonbank lender, the loans lost the benefit of exporting the bank's home state law.<sup>15</sup>

In addition to the issue of loans that were valid when made, the issue of who is the true lender in a bank partnership—and whether it should matter—also calls the validity of the bank-partnership model into question. Some courts have held that the contractual relationship between the borrower and the bank controls<sup>16</sup> because looking beyond the contract would intrude on the powers provided to banks by federal law.<sup>17</sup> Other courts have held that the party with the “predominant economic interest” in the loan (i.e., the most to gain or lose based on the loan's performance) is the true lender and that the laws that apply to that entity govern the loan.<sup>18</sup> Concerns about true lender issues have caused firms and their bank partners to distort their contractual relationships in ways that seek to avoid invalidation of the loan but do not provide greater efficiency or benefit to customers.<sup>19</sup>

#### Competitive Equity

Nonbank fintech firms turn to banks to avoid the inefficiencies of state-by-state regulation, indicating that banks enjoy a competitive advantage, despite the similarity of the products and services being offered. For example, the loans that Colorado is attacking would be unquestionably legal if made by a bank. The disparate treatment makes even less sense when one considers that nonbank lenders are governed by the same federal consumer protection laws as banks.<sup>20</sup> Likewise, nonbank money transmitters are subject to federal consumer protection and anti-money-laundering law<sup>21</sup> similarly to banks.

This disparate treatment of similar products runs contrary to “the principle that institutions offering similar products should be subject to similar rules.”<sup>22</sup> Senator Dale Bumpers made this statement in the context of the debate about whether competitive fairness demanded that interest rate exportation be provided to state banks on the same terms as it was provided to federal banks.<sup>23</sup> A similar dynamic exists today between banks and nonbank fintech firms, where the differences in regulation are not driven by differences in risks generated by the firms' activity but by the charter or license status of the firms.

#### Political Equity

Competitive equity isn't the only type of fairness imperiled by state-by-state regulation of fintech firms. There is also the risk that a state, especially a state that represents a large share of the market, will end up de facto regulating the national market. The New York Department of Financial Services (NYDFS) acknowledged as much in its complaint

against the Office of the Comptroller of the Currency (OCC) when NYDFS sought to stop the OCC's fintech bank charter (discussed below).<sup>24</sup> NYDFS's statement that "New York is a global financial center and, as a result, [NY]DFS is effectively a global financial regulator"<sup>25</sup> is not inaccurate, but it highlights the problem. While NYDFS may have global reach, it does not have global political accountability. The citizens of other states have no means of democratic redress against the NYDFS (or the regulators of other large and systemically important states).

This dynamic presents a problem for fintech firms because they will face significant economic and regulatory pressure to limit their national product offering to conform to state specific rules. For example, New York's licensing regime for virtual currencies—the "BitLicense"—claims a sweeping jurisdiction, including any virtual currency transaction (as defined by the rule) that involves New York or a New York resident.<sup>26</sup> Given New York's importance to the financial system, it is questionable whether a firm seeking to establish a viable business could elect to avoid New York. Given the breadth of New York's rules, firms would rightly be concerned that even if they intended to avoid New York, the NYDFS would consider them covered by New York law. Even if a firm were to successfully defend an enforcement action on the grounds that the NYDFS lacked jurisdiction, the diversion of resources away from competition to litigation could fatally cripple a company.

If firms must change their national products to comply with a specific state's rules, then the residents of other states must also bear with their choices being limited by rules they have no control over. State regulators and legislators have an incentive to act in the best interests of their state (or the most powerful political factions therein), even if this means imposing costs on other states.<sup>27</sup> Conversely, federal law and regulation is driven ultimately by the laws Congress passes, and Congress is accountable to the country as a whole.

#### WAYS TO ADDRESS THE PROBLEMS POSED BY INCONSISTENT STATE-BY-STATE REGULATION

While the problems posed by inapt state regulation of nonbank fintech firms are real, there are solutions. Federal regulators, the states themselves, and Congress all have options that can help modernize and streamline fintech regulation and make it more efficient and equitable.

##### Federal Regulators

Federal regulators—in particular the OCC, the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve (Fed)—can address at least some of the problems facing fintech lenders and money transmitters.

- *Address "valid when made" and "true lender" issues via regulation.* The United States solicitor general and the OCC have correctly taken the position that the Second Circuit's Madden decision is incorrect as a matter of existing law and that a national bank's power to lend includes the power to sell the loan and have it remain valid.<sup>28</sup> The Federal Deposit Insurance Act<sup>29</sup> should be interpreted in parallel<sup>30</sup> to convey the same power to state banks. Therefore, regulators could clarify via rulemaking that a bank may sell a loan without undermining the loan's validity. Additionally, bank regulators should clarify that the power of a bank to make a loan it plans to sell does not hinge on which party maintains the "predominant economic interest" in the loan.
- *Provide a viable bank charter option for non-depository firms.* The OCC has announced its intention to offer a special-purpose national bank charter for nondepository fintech firms.<sup>31</sup> The OCC should continue to move this project forward and should structure the charter so that it is a viable option for smaller entities, omitting needlessly onerous

or restrictive requirements. The OCC should also vigorously defend its effort against the lawsuits brought by the NYDFS<sup>32</sup> and the Conference of State Bank Supervisors.<sup>33</sup> The Fed should support the inclusion of special-purpose national banks into the Federal Reserve system as needed.

Additionally, the FDIC should clarify that the definition of “deposit” for the purpose of federal law does not include money provided to fintech banks for the purposes of money transmission.<sup>34</sup> The FDIC and the Fed should also support efforts by state banking regulators to pursue innovative charter structures comparable to the OCC’s effort, including supporting any necessary changes to federal law.

#### The States

The States could still play a major and productive role in improving fintech regulation. While they are making some efforts already,<sup>35</sup> those efforts revolve around making it easier for firms to apply for multiple licenses and deal with multistate supervision.<sup>36</sup> They do not address the core problems posed by the requirement for multiple licenses and the inconsistency of state law. Truly effective reform likely will require collaboration with the federal government.

- *Harmonization and reciprocity.* The states do not need the federal government’s help to make their laws more uniform and grant reciprocity for licensed entities. However, the history of state regulation in this space is not heartening. For example, Congress called on the states to harmonize their money transmission laws in 1994,<sup>37</sup> but to date only seven states have adopted the Uniform Money Services Act established by the Uniform Law Commission for that purpose.<sup>38</sup> The states could work with Congress to pass legislation that would allow for reciprocity for state-regulated nonbank financial services companies or for the exporting of certain legal provisions (for example, provisions governing interest),

akin to the powers granted to state-chartered banks. States would remain the primary regulator, but it would be easier for state-licensed entities to compete on a national scale.

- *Innovative chartering and licensure.* Rather than opposing the OCC’s efforts at innovation, the states should emulate (and possibly surpass) those efforts by creating new chartering options for nondepository institutions. To the extent such efforts are inhibited by existing federal law,<sup>39</sup> the states should work with Congress to remove those impediments to facilitate salutary competition between national banks and state-chartered or state-licensed financial institutions.

#### Congress

Given the interstate nature of the commerce in question, Congress has the broadest authority to address the issues posed by inapt state regulation of fintech.<sup>40</sup> As discussed above, there are several areas where Congress may be needed to help state-licensed entities compete at the national level. Additionally, there are other areas of federal law that can be clarified or improved to help rationalize the regulation of fintech firms.

- *Codify “valid when made” and clarify “true lender.”* Congress could provide regulatory certainty by explicitly codifying the longstanding common-law rule of “valid when made”<sup>41</sup> and making clear that a firm does not need to maintain a “predominant economic interest” in a loan to be considered the true lender. This clarification would assist in protecting existing powers held by national and state banks.
- *Change the law to help state-based innovation.* Congress could change federal law to allow state-licensed or -chartered entities to export key provisions of their home state’s law (for example, provisions governing interest) and

mandate reciprocity for certain licensed activities (for example, money transmission licensing). Congress also could amend the Federal Deposit Insurance Act and other laws to allow state-chartered nondepository banks to enjoy the relevant powers of a bank granted to insured depositories.

- *Modernize tools to resolve uninsured nondepository banks.* As Acting Comptroller Keith Noreika recently testified, the power of the OCC to place a noninsured bank in receivership relies on law going back to the passage of the National Bank Act and needs to be modernized.<sup>42</sup>

Additionally, Congress could amend the bankruptcy code to expand its application beyond noninsured state banks that are members of the Federal Reserve system to include, at a minimum, nondepository national banks.<sup>43</sup> In cases where receivership is unlikely to be necessary to protect customers, failing firms should go through bankruptcy.

## CONCLUSION

There are many virtues to the United States' federal system, but as the Founders understood when they granted Congress the power to regulate interstate commerce,<sup>44</sup> there are times when the patchwork of inconsistent state regulations is counterproductive or even pernicious. The regulation of nonbank fintech lenders and money transmitters presents one such case, with inconsistent state regulation harming efficiency, competitive equity, and political equity. Both the federal government and the states themselves have options available to help address these problems and their underlying causes. They should consider exercising those options.

## NOTES

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Fintech Frontier," *Vanderbilt Journal of Entertainment & Technology Law* (forthcoming).

2. Yuliya Demyanyk and Daniel Kolliner, "Peer-to-Peer Lending Is Poised to Grow," Federal Reserve Bank of Cleveland, August 14, 2014.
3. "Ripple eliminates the risk that payments will not reach the targeted payee once the payer initiates the transaction. . . . Either the entire transaction happens or none of the steps happen at all." Marcel T. Rosner and Andrew Kang, "Understanding and Regulating Twenty-First Century Payment Systems: The Ripple Case Study," *Michigan Law Review* 114 (2016): 661.
4. Usman Ahmed et al., "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises," *Innovations: Technology, Governance & Globalization* 10, no. 3-4 (2015).
5. Kevin V. Tu, "Regulating the New Cashless World," *Alabama Law Review* 65, no. 1 (2013): 77, 89. Note, however, that not all states exempt other state banks from licensing. Bryan Cave LLP, "The Latest in Money Transmitter Licensing," February 19, 2015, slide 20.
6. The National Bank Act, 12 U.S.C. § 85 (2015), allows national banks to charge the amount of interest under their home state's laws nationwide. The Depository Institutions Deregulation Act of 1980, 12 U.S.C. § 1831d(a) (2015), grants the same power to state-chartered, federally insured banks. See also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978); 12 C.F.R. § 7.4001(a) (1996); 12 C.F.R. § 560.110(a) (1997) (allowing banks and federal savings associations to use their home state's definition of what constitutes interest nationwide); *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996) (upholding same); FDIC, General Counsel's Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act 63 Fed. Reg. 74 (1998) (citing 12 C.F.R. § 7.4001(a)(1997) and 12 C.F.R. § 560.110(a)(1997)).
7. John L. Douglas, "New Wine into Old Bottles: Fintech Meets the Bank Regulatory World," *North Carolina Banking Institute Journal* 20, no. 1 (2016): 17, 32; letter from Manuel P. Alvarez, chief compliance officer for Affirm, Inc., to US Treasury, September 30, 2015, 7; letter from Sam Hodges, managing director for Funding Circle, and Conor French, general counsel, to US Treasury, September 30, 2015, 27; letter from Mitria Wilson for Oportun to US Treasury, September 30, 2015, 11-14; letter from Robert Lavet, chief legal officer for Social Finance, Inc., to US Treasury, September 30, 2015, 3-5; Tu, "Regulating the New Cashless World," 87-88.
8. Obtaining licenses and maintaining compliance can cost over \$1 million and take more than two years. Douglas, "New Wine into Old Bottles," 46.
9. Douglas, "New Wine into Old Bottles," 32-34; Tu, "Regulating the New Cashless World," 91.
10. Thomas W. Miller Jr. and Harold A. Black, "Examining Arguments Made by Interest Rate Cap Advocates," in *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers*, ed. Hester Peirce and Benjamin Klutsey (Arlington, VA: Mercatus Center at George Mason University, 2016), 346-50 (listing different state law requirements governing interest charged on loans).
11. Tu, "Regulating the New Cashless World," 112.
12. For example, Lending Club, Prosper, and PayPal all originate loans through WebBank, a state-chartered Utah industrial bank. Square partners with Celtic Bank, also a state-chartered Utah industrial bank.

- and Intuit partners with Cross River Bank, a state-chartered New Jersey bank.
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  14. Colleen Honigsberg, Robert J. Jackson Jr., and Richard Squire, "What Happens When Loans Become Legally Void? Evidence from a Natural Experiment" (Columbia Business School Research Paper No. 16-38, Columbia University, New York, December 2, 2016), 28-29.
  15. Amended Complaint, Julie Ann Meade, Administrator, Uniform Consumer Credit Code v. Avant of Colorado LLC d/b/a Avant, and Avant Inc., No. 17CV30377 (D. Colo. Mar. 9, 2017); Amended Complaint, Julie Ann Meade, Administrator, Uniform Consumer Credit Code v. Marlette Funding LLC d/b/a Best Egg, No. 17CV30376 (D. Colo. Feb. 15, 2017).
  16. See, for example, *Krispin v. May Dept. Stores Co.*, 218 F.3d 919 (8th Cir. 2000); *Sawyer v. Bill Me Later, Inc.*, No. 2:11-cv-00988, 2014 U.S. Dist. LEXIS 71261 (D. Utah May 23, 2014); *Hudson v. ACE Cash Express, Inc.*, No. 01-1336-C, 2002 U.S. Dist. LEXIS 11226, at \*4, \*16 (S.D. Ind. May 30, 2002); *Beechum v. Navient Solutions, Inc.*, No. 2:15-cv-08239-JGB-KK (C.D. Cal. Sept. 20, 2016).
  17. See, for example, *Hudson* at \*16 ("[t]he plaintiff invites the courts to draw boundaries between federal and state bank regulation depending on the subjective purpose of those engaged in the transaction and/or the precise extent of financial risk accepted by the national bank. The court sees no basis for drawing jurisdictional boundaries in such an uncertain and unpredictable way.>").
  18. See, for example, *CashCall, Inc. v. Morrissey*, No. 12-1274, 2013 W. Va. LEXIS 587, at \*18 (W. Va. May 30, 2014); *Spitzer v. County Bank of Rehoboth Beach*, 846 N.Y.S.2d 436 (N.Y. App. Div. 2007); *Kane v. Think Finance, Inc.*, No. 14-cv-7139, 2016 WL 183289 (E.D. Pa. 2016) (refusing to grant a motion to dismiss a complaint of conspiracy to avoid Pennsylvania usury law. The defendant was a nonbank lender who partnered with a bank and a Native American tribe.); *Consumer Financial Protection Bureau v. CashCall, Inc.*, CV 15-7522-JFW (RAOx) (C.D. Cal. 2016) (summary judgment was granted to CFPB on August 31, 2016).
  19. Kevin Wack, "Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges," *American Banker*, February 26, 2016.
  20. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, 10.
  21. Knight, "Federalism and Federalization," 32-33.
  22. 126 Cong. Rec. 6,907 (1980) (statement of Sen. Dale Bumpers).
  23. Knight, "Federalism and Federalization," 13-14.
  24. Complaint for Declaratory and Injunctive Relief, Maria T. Vullo v. Office of the Comptroller of the Currency, 1:17-cv-03574-NRB (S.D.N.Y. May 12, 2017).
  25. *Ibid.*, ¶10.
  26. Knight, "Federalism and Federalization," 39-40.
  27. Samuel Issacharoff and Catherine Sharkey, "Backdoor Federalization," *UCLA Law Review* 53, no. 6 (2006): 1353, 1387-88; Paul Nolette, *Federalism on Trial: State Attorneys General and National Policymaking in Contemporary America* (Lawrence, KS: University Press of Kansas, 2015); Knight, "Federalism and Federalization," 72, 82-83.
  28. Brief for the United States as Amicus Curiae Supporting Petitioners, *Midland Funding, LLC v. Madden*, No. 15-610 (U.S. May 24, 2016).
  29. Codified at 12 U.S.C. § 1831d(a) (2014).
  30. "The historical record clearly requires a court to read the parallel provisions of DIDA and the Bank Act *in pari materia*. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted the same way." *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 827 (1st Cir. 1992). See also FDIC, General Counsel's Opinion No. 10; Interest Charges under Section 27 of the Federal Deposit Insurance Act, 63 Fed. Reg. 74 (1998).
  31. Office of the Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016.
  32. Complaint for Declaratory and Injunctive Relief, Maria T. Vullo v. Office of the Comptroller of the Currency, 1:17-cv-03574-NRB (S.D.N.Y. May 12, 2017).
  33. Complaint for Declaratory and Injunctive Relief, Conference of State Bank Supervisors v. Office of the Comptroller of the Currency, 1:17-cv-00763-JEB (D.D.C. Apr. 26, 2017).
  34. Lawrence D. Kaplan et al., "The OCC's Proposed Fintech Charter: If It Walks Like a Bank and Quacks Like a Bank, It's a Bank," Paul Hastings LLP, December 15, 2016 (acknowledging that funds provided to a bank for money transmission purposes may potentially constitute deposits under the Federal Deposit Insurance Act (12 U.S.C. § 1813(i)).
  35. Conference of State Bank Supervisors, "CSBS Announces Vision 2020 for Fintech and Non-Bank Regulation," news release, May 10, 2017.
  36. *Ibid.*
  37. Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(b)(1-5) (1994).
  38. Uniform Law Commission, "Money Services Act," Enactment Status Map, accessed June 30, 2017.
  39. For example, the Federal Deposit Insurance Act defines "State Bank" as a bank "engaged in the business of receiving deposits" (12 U.S.C. § 1813(a)(2)(A)) and limits the ability to export home-state interest rates to "State-chartered depository institutions" (12 U.S.C. § 1813(d)(a) (2015)).
  40. Knight, "Federalism and Federalization," 60-61.
  41. Section 581 of the Financial CHOICE Act, H.R. 10, 115th Cong. (2017), Section 925 of the House Financial Services Appropriations Bill for FY 2018, H.R. 3280, 115th Cong. (2017), and the Protecting Consumers' Access to Credit Act of 2017, H.R. 3299, 115th Cong. (2017) seek to address this issue; see also Protecting Consumers' Access to Credit Act of 2017, 115th Cong. (2017).
  42. Testimony of Keith A. Noreika, Acting Comptroller of the Currency, before the US Senate Committee on Banking, Housing, and Urban Affairs, June 22, 2017, 35-36.
  43. 11 U.S.C. §§ 109(b)(2) and (d) (2006) preclude almost all banks from utilizing bankruptcy. See also Richard M. Hynes and Steven D. Walt, "Why Banks are Not Allowed in Bankruptcy," *Washington and Lee Law Review* 67, no. 3 (2010): 985, 986-87.
  44. 44 U.S. Const. art. I, § 8, cl. 3.

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# MERCATUS ON POLICY

## Risks to Innovative Credit Posed by Emerging Regulatory and Litigation Trends

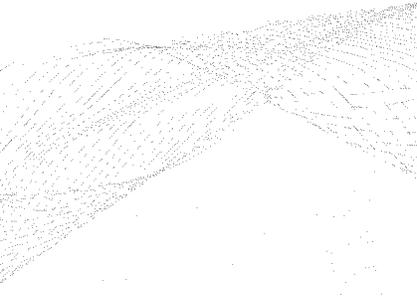
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**N**onbank online “fintech” lenders (sometimes known as *marketplace* or *peer-to-peer* lenders<sup>1</sup>) have emerged as an important source of credit for individuals and small businesses. In 2015, these fintech lenders issued approximately \$36.5 billion in loans in the United States.<sup>2</sup> Although fintech lenders were initially discussed as a possible existential threat to banks, many such lenders rely on banks to facilitate credit.<sup>3</sup> These innovative firms could expand access to credit for millions of American consumers and small businesses that are credit constrained. Unfortunately, recent regulatory and litigation developments that call into question the right of banks to issue and sell loans threaten to impede access to this new credit source. This policy brief outlines the threats to the bank-partnership model used by some fintech lenders, explains why the survival of the model matters, and offers suggestions for action.

### THE ROLE OF BANKS IN FINTECH LENDING

Banks play an important role for many fintech lenders, including Lending Club, Prosper, PayPal Working Capital, Square, and Intuit.<sup>4</sup> Those lenders work with a bank to originate a loan that the bank sells to the lender after a short period of time. The lender—which may sell, securitize, or retain the loan on its balance sheet—services the loan and collects payment.<sup>5</sup>

Lenders partner with banks in part because of regulation. Fintech lenders, being creatures of the Internet, are capable of extending credit from coast to coast, but they are subject to onerous state-by-state regulation. Under federal law, banks are able to “export” the

interest rate requirements of their home state for loans they make nationwide.<sup>6</sup> This exportation includes not only the maximum allowable interest rate, but also the law governing what constitutes interest.<sup>7</sup> By partnering with a bank, nonbank lenders can provide a consistent product, which is governed by the law of the bank's home state, and they can avoid having to be licensed by every state in which they extend credit.<sup>8</sup>

Lenders and borrowers benefit. The US Department of the Treasury found that these arrangements have helped fintech lenders improve the credit market.<sup>9</sup> For some borrowers, fintech lenders provide cheaper credit.<sup>10</sup> For others, fintech lenders provide greater access. For example, PayPal Working Capital, which partners with a bank to issue loans to small businesses, has been able to extend credit disproportionately to underserved populations and to areas that have seen a significant decline in the number of banks serving them.<sup>11</sup>

#### EMERGING THREATS TO THE BANK-PARTNERSHIP MODEL

Despite its benefits, this model might not survive. Recent litigation has undercut the assumption that a nonbank entity can buy a loan from a bank and benefit from the bank's ability to export rates and terms. This ability is key to the bank-partnership model. Although the recent cases generally do not involve fintech lenders, those cases implicate such lenders and have already had a negative effect on consumers' access to credit.

##### The Threat to "Valid when Made"

The ruling of the US Court of Appeals for the Second Circuit in *Madden v. Midland Funding LLC*<sup>12</sup> calls into question the venerable common-law principle that a loan that is valid and nonusurious at its inception cannot subsequently become usurious (the "valid-when-made" doctrine).<sup>13</sup> In the *Madden* case, a New York borrower opened a credit card account with a national bank that charged an interest rate that was permitted by the bank's home state laws but that exceeded New York's usury cap. When the borrower defaulted, the bank sold the debt, which eventually was purchased by Midland Funding, a nonbank debt purchaser. Midland Funding sought to collect the outstanding debt,

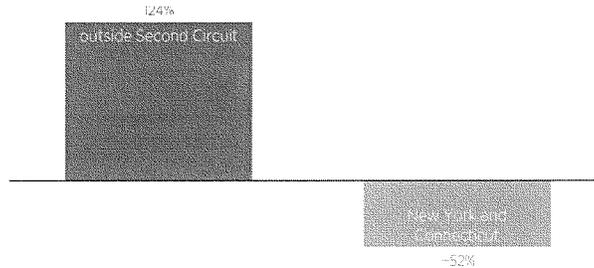
including interest that accrued after the debt had been sold. The borrower sued, and the Second Circuit held that the National Bank Act's interest rate export did not cover the nonbank debt buyer. The court reasoned that its decision did not significantly infringe on the powers of the national bank because the bank could still sell the debt, albeit either to a more limited pool of buyers or at a discount.

Midland Funding appealed the decision to the Supreme Court. The Supreme Court requested the solicitor general's view, and the solicitor general, along with the Office of the Comptroller of the Currency (OCC), opined that the Second Circuit got the law wrong and that the power to make loans included the power to sell loans to nonbank entities and have the loans retain their validity.<sup>14</sup> Notwithstanding their disagreement with the appellate court on the law, the solicitor general and the OCC argued on procedural grounds that the Supreme Court should not take the case, and the Supreme Court declined to do so.<sup>15</sup>

Although the *Madden* case did not involve fintech lenders, the risk that a bank loan purchased by a nonbank could become invalid has direct implications for the bank-partnership model. The case has produced considerable fallout in the Second Circuit, including a significant reduction in credit for borrowers with lower credit scores (who would be charged a higher rate). Professors Colleen Honigsberg, Robert J. Jackson, and Richard Squire have documented this decline.<sup>16</sup> As shown in figure 1, they find that in 2015 in New York and Connecticut (states in the Second Circuit<sup>17</sup>) the number of loans made by leading marketplace lending platforms to borrowers with FICO credit scores below 625 *decreased* by 52 percent relative to 2014, while in other circuits the number of loans for comparable borrowers *increased* by 124 percent.<sup>18</sup> Conversely, loan growth for borrowers with FICO scores above 700 (who would be less likely to be charged interest in excess of New York's or Connecticut's usury limits) were comparable between New York and Connecticut and other circuits.<sup>19</sup>

##### Who Is the True Lender—and Should It Matter?

In *Madden*, there was no dispute about who the lender was. The bank issued the borrower a credit card with the expectation that the borrower would remain a bank customer and sold the debt only when it became

FIGURE 1. GROWTH IN LOAN VOLUME FOR BORROWERS WITH A FICO CREDIT SCORE UNDER 625 AFTER THE *MADDEN* DECISION

Source: Colleen Honigsberg, Robert J. Jackson, Jr., and Richard Squire, "What Happens when Loans Become Legally Void? Evidence from a Natural Experiment" (Columbia Business School Research Paper No. 16-38, December 2, 2016), 28-29. (Finding a decline in loan volume from studied lenders in 2015 for borrowers with FICO scores below 625 in New York and Connecticut, while finding an increase in states not covered by the *Madden* decision).

nonperforming. Conversely, in the bank-partnership model, the expectation has been that the bank would promptly sell the loan to the fintech lender, which would then own and maintain the customer relationship. This situation raises the specter of the "true lender" doctrine, which has significant implications for what law applies to a loan. If the nonbank entity is deemed to be the true lender, then it does not enjoy broad federal preemption but is instead bound by state usury laws.

Courts take different approaches to the true lender question. Some courts have looked only to the loan contract.<sup>20</sup> For those courts, looking beyond the contract to factors such as the parties' subjective intent or the risk borne by the bank would add uncertainty and be inconsistent with the exemption from state usury laws that banks enjoy under federal law.<sup>21</sup> However, other courts have looked beyond the contract to the underlying economic reality of the loan at its inception.<sup>22</sup> Those courts consider the role the bank (or tribe) and nonbank perform in the loan process, including advertising, setting underwriting criteria, making loan decisions, and underwriting specific borrowers. The courts also look at the amount of risk borne by each party. If a bank sells a loan quickly or has a standing agreement or prepaid account with the nonbank entity, courts may consider this evidence that the nonbank entity is the actual lender.

*Consumer Financial Protection Bureau (CFPB) v. CashCall* provides a recent example of the difficulties

posed by looking beyond the contract. The CFPB sued a nonbank lender (CashCall) that partnered with Western Sky Financial (WSF), a corporation operating under the law of the Cheyenne River Sioux Tribe (CRST) to issue loans. The contract listed WSF as the lender, and a choice-of-law provision stipulated that the contract was governed by CRST law. Moreover, WSF employees performed underwriting and made lending decisions. Nevertheless, the court found CashCall to be the true lender. The court based its decision on the conclusion that CashCall bore the entire economic risk of the transaction because WSF was contractually insulated from default risk and CashCall funded a reserve to pay for two days' worth of loans in advance.<sup>23</sup> The court also invalidated the contract's choice-of-law provision because it found that the CRST did not have sufficient ties to the transaction (even though lending decisions were made in the CRST's jurisdiction).<sup>24</sup> The court then found that the law of the borrowers' home state, instead of CashCall's home state, should apply because the borrowers applied for, paid for, and received funds in their home state.<sup>25</sup>

The court's analysis in that case highlights the danger of looking beyond the contract. Although it is plausible to view the transaction as occurring in the borrowers' state, it is equally or even more plausible to view the borrowers as coming to the lender's state to avail themselves of the lender's state's law. The Supreme Court in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.* noted that a borrower was always able to go to the lender's state to avail herself of the

lender's state laws and that applying for a credit card via the mail was similar.<sup>26</sup> Applying for a loan online is a natural continuation that does not justify a departure from this reasoning. The *CashCall* court's analysis is also inconsistent with the Supreme Court's determination in *Marquette* that the lender's home state bore the closest nexus to the loan transaction and that defining "location" by where the credit was received would introduce significant confusion.<sup>27</sup>

Fintech lenders are experiencing the fallout from *Madden* and the true lender cases. A New York borrower sued Lending Club for allegedly making a usurious and invalid loan with WebBank's "sham" participation.<sup>28</sup> Regulators are also starting to consider whether loans made by fintech lenders with bank partnerships are governed by state law. For example, Colorado has notified fintech lenders that the state considers the loans to be governed by its law.<sup>29</sup> Lenders, for their part, have changed their contracts with their bank partners to tie the bank's compensation more closely to the long-term performance of the loan.<sup>30</sup>

When lenders change their relationships with banks solely to mitigate regulatory risk, the process is likely to introduce more complexity and cost to the borrower. Why should it matter who the true lender is from a regulatory perspective? If a loan is acceptable for a bank to make, why should a nonbank entity be prohibited from making the same loan? Raising questions about the validity of marketplace loans blocks innovative fintech lenders' efforts to improve access to credit for marginal borrowers.

#### WHAT CAN BE DONE

To encourage innovation and access in lending, a clear, consistent regulatory approach is needed. Several potential and nonexclusive paths can be pursued to establish such an approach.

##### State Coordination

States could change their lending regulations to make it easy for lenders licensed in one state to lend in other states without having to comply with the laws of both states. Although state regulators have discussed such an approach,<sup>31</sup> those discussions may not result in any meaningful change. First, states could have changed their laws to permit greater uniformity for banks in the

past, but federal law intervention was necessary to provide reliable exportation. There is little reason to think that this time will be different. Second, even if states were able to establish a uniform standard, state laws could change, so nonbank lenders—unlike their bank competitors—would have to engage in costly, constant monitoring.

##### Federal Regulatory Relief

The Federal Deposit Insurance Corporation (FDIC) and OCC could issue a regulation clarifying that a bank can sell a loan without compromising exportation. Such a regulation could be modeled on a similar clarifying regulation by the FDIC and OCC about what constitutes interest.<sup>32</sup> Such a federal regulation would preempt state law,<sup>33</sup> and it would provide certainty to lenders and their bank partners.

##### Expanded Bank Chartering

Fintech lenders could become banks themselves, an approach that would obviate the need for a bank partnership and reduce the complexity and uncertainty of loan transactions. The OCC has proposed creating a bank charter for fintech firms, including lenders.<sup>34</sup> Such a charter would give fintech firms the powers granted to national banks by the National Bank Act. Although this change could be an important step in equalizing the regulatory landscape, fintech firms would not avail themselves of such a charter if obtaining and maintaining the charter were unduly difficult or expensive. Additionally, while a charter might benefit fintech firms, banks seeking to sell loans to nonbank lenders would still run into problems because of the legal uncertainty. The result would be higher costs for borrowers.

##### Legislation

Congress also could act to create a clear and effective regulatory environment for banks and fintech lenders. For example, codifying the principle of "valid-when-made" would address the concerns raised by the *Madden* decision.<sup>35</sup> Likewise, legislation could clarify whether a loan should be considered a bank loan if it was sold by a bank soon after it was made and without the bank's retaining ongoing default risk.

## CONCLUSION

Fintech lenders present an opportunity to expand credit access and quality. Although such lenders should be subject to appropriate regulation, the regulation must work with the fundamental economic reality of the market. Ensuring that regulations do not burden fintech lenders more heavily than their bank competitors are burdened and that the validity of their loans is not in doubt are important steps toward helping realize the promises of innovation.

## NOTES

1. Defined narrowly, *marketplace lending* would involve a two-sided market in which the lender sells the loans it generates, and *peer-to-peer* lending would involve individuals funding loans for other individuals. Many leading companies, including Lending Club and Prosper, use both these models for at least some of their loans. However, the two terms are often used more broadly to encompass a wider range of innovative nonbank lenders. See, for example, California Department of Business Oversight, "California DBO Announces Inquiry into 'Marketplace' Lending Industry," December 11, 2015. The broader definition is used in this paper.
2. Tim Sablik, "Tomorrow's Lenders?," *Econ Focus*, Richmond Federal Reserve Bank, Second Quarter 2016.
3. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, 5-8.
4. Lending Club, Prosper, and PayPal all originate loans through WebBank, a state-chartered Utah industrial bank. Square partners with Celtic Bank, also a state-chartered Utah industrial bank, and Intuit partners with Cross River Bank, a New Jersey state-chartered bank.
5. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, 5-8.
6. The National Bank Act grants this power to nationally chartered banks (12 U.S.C. § 85 (2015)). The Depository Institutions Deregulation Act of 1980 grants this power to state-chartered banks (12 U.S.C. § 1831d(a) (2015)); see also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 US 299 (1978).
7. See 12 C.F.R. § 7.4001(a). See also 12 C.F.R. § 560.110(a); *Smiley v. Citibank (South Dakota)*, N.A. 517 U.S. 735 (1996).
8. US Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, 6.
9. *Ibid.*, 21.
10. Yuliya Demyanyk and Daniel Kolliner, *Peer-to-Peer Lending Is Poised to Grow*, Federal Reserve Bank of Cleveland, August 14, 2014.
11. Usman Ahmed et al., "Filling the Gap: How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises," *Innovations: Technology, Governance & Globalization* 10, no. 3-4 (2015).
12. *Midland Funding, LLC, et al., v. Saliha Madden*, 786 F.3d 246 (2d Cir. 2015).
13. The Supreme Court has embraced this doctrine at least since 1833. See *Nichols v. Fearson*, 32 US 103, 109 (1833) (holding that "a contract, which, in its inception, is unaffected by usury, can never be invalidated by any subsequent usurious transaction"). However, the doctrine predates that case.
14. Brief for the United States as amicus curiae supporting petitioners, *Midland v. Madden*, No. 15-610 (May 24, 2016), 6.
15. *Midland Funding v. Madden*, No. 15-610, 136 S. Ct. 2505 LEXIS 4211 (June 27, 2016), cert. denied.

16. Colleen Honigsberg, Robert J. Jackson, Jr., and Richard Squire, "What Happens when Loans Become Legally Void? Evidence from a Natural Experiment" (Columbia Business School Research Paper No. 16-38, Columbia University, New York, December 2, 2016).
17. While New York and Connecticut usury law can void usurious loans, in Vermont (which is also in the Second Circuit), the loan is modified to become nonusurious. Hence, Honigsberg, Jackson, and Squire focus on the loan environment in New York and Connecticut. *Ibid.*, 16 (also noting that the inclusion of Vermont made little difference in the results).
18. *Ibid.*, 28-29.
19. *Ibid.*
20. See, for example, *Krispin v. the May Department Stores Co.*, 218 F.3d 919 (8th Cir. 2000); *Sawyer v. Bill Me Later, Inc.*, No. 2:11-cv-00988, 2014 U.S. Dist. LEXIS 71261 (D. Utah May 23, 2014); *Hudson v. ACE Cash Express, Inc.*, No. 01-1336-C, 2002 US Dist. LEXIS 11226, at \*4, \*16 (S.D. Ind. May 30, 2002); *Beechum v. Navient Solutions, Inc.*, No. 2:15-cv-08239-JGB-KK (C.D. Cal. Sept. 20, 2016).
21. For example, *Hudson* at 16 states that the plaintiff "invites the courts to draw boundaries between federal and state bank regulation depending on the subjective purpose of those engaged in the transaction and/or the precise extent of financial risk accepted by the national bank. The court sees no basis for drawing jurisdictional boundaries in such an uncertain and unpredictable way."
22. See, for example, *CashCall, Inc. v. Morrisey*, No. 12-1274, 2013 W. Va. LEXIS 587 at 18 (W. Va. May 30, 2014); *Spitzer v. County Bank of Rehoboth Beach*, 846 N.Y.S.2d 436 (N.Y. App. Div. 2007); *Kane v. Think Finance, Inc.*, Civ. No. 14-cv-7139, 2016 WL 183289 (E.D. Pa. 2016) (refusing to grant a motion to dismiss a charge of conspiracy to avoid Pennsylvania usury law by a nonbank lender who partnered with a bank and a Native American tribe); *Consumer Financial Protection Bureau v. CashCall, Inc.*, CV 15-7522-JFW (RAOX) C.D. Cal. (summary judgment granted August 31, 2016).
23. *CashCall* at 8.
24. *Ibid.* at 9.
25. *Ibid.* at 11.
26. *Marquette* at 310-12.
27. *Ibid.* The court in *Marquette* based the decision of where a bank was located for purposes of the law on the bank's organization certificate, not on the strength of ties to a particular state. The court's strength of ties analysis was used to rebut Minnesota's argument that the borrower's state was the relevant location.
28. *Ronald Bethune v. Lending Club Corporation*, S.D.N.Y. 1:16-cv-02578, filed April 6, 2016.
29. Telis Demos and Peter Rudegeair, "Greater Scrutiny Looms for Rent-a-Charter Deals," *Wall Street Journal*, August 21, 2016.
30. See, for example, Kevin Wack, "Lending Club Tweaks Business Model in Effort to Thwart Legal Challenges," *American Banker*, February 26, 2016; Kirby Smith, "Banking on Preemption: Allowing National Bank Act Preemption for Third-Party Sales," *University of Chicago Law Review* 83 (2016): 1631-82.
31. Lalita Clozel, "States Hurry to Boost Their Fintech Appeal in Wake of OCC Plan," *American Banker*, December 9, 2016.
32. See 12 C.F.R. § 7.4001(a); see also 12 C.F.R. § 560.110(a).
33. *Smiley v. Citibank (South Dakota)*, N.A. 517 U.S. 735 (1996).
34. Office of Comptroller of the Currency, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016.
35. Rep. Patrick McHenry (R-NC) introduced the Protecting Consumers' Access to Credit Act of 2016 (H.R. 5724) on July 11, 2016. For the bill to become law, it would have to be reintroduced in the new Congress.

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## BankThink Innovation Will Stall Without a Regulatory Fintech 'Sandbox'

By **Brian Knight**

Published November 15 2016, 11:00am EST

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All policymakers and regulators claim to love innovation, especially if it might help the underserved. Unfortunately, regulators' thinking often fails to keep up with their rhetoric.

A particularly frustrating example is the emerging opposition from some in the government, including Sen. Mark Warner, D-Va., and Comptroller of the Currency Thomas Curry, to a regulatory sandbox for financial services. Sandboxes provide a space where companies can try new ideas, under the watchful eye of regulators, but with some degree of regulatory forbearance, including the waiver of certain rules or limits to enforcement actions.

Opponents fret that a sandbox would provide companies with a way to avoid consumer protection laws. However, sandboxes need not be a Hobbesian "war of all against all," where the powerful prey on the weak. Instead — provided they are done right — sandboxes can offer an environment where companies can innovate while ensuring consumers are protected.

Fear and uncertainty about regulatory risk are major impediments to companies pursuing innovative financial products. Concern is especially high for innovators trying to serve populations who need help the most. The fear of facing the regulator's wrath chills innovation, deprives consumers and encourages firms — especially small innovators — to stay under the radar. In addition to harming companies, innovation and consumers, this state of play isn't good for regulators. Refusing to let innovators experiment in a permissive environment keeps regulators in the dark. For regulators, who all too often have to play catch up, this reality ought to be reason enough for them to accommodate innovators.

Regulatory sandboxes are a potential solution to innovators' and regulators' problems. In the U.K., the Financial Conduct Authority runs a sandbox program focused on financial technology companies. This sandbox allows firms to test new products that regulators deem are truly innovative and potentially beneficial to consumers. (Of course, one wonders whether regulators can judge whether a product meets these criteria. Regulators, like the rest of us, can't see the future until it's here.) The FCA also requires firms to have appropriate consumer safeguards, such as the wherewithal to compensate consumers who are harmed if the test goes awry.

Likewise, a U.S. sandbox could help encourage innovation without jeopardizing consumers. In exchange for greater transparency from the company, regulators could agree to limit the company's potential liability for future consumer protection violations. In this model, companies would not be able to escape the responsibility for compensating inadvertently harmed consumers, but would have the assurance that the government would not assess fines and penalties. Of the three justifications for sanctioning a company — compensation, punishment and deterrence — only the first is appropriate for companies operating with transparency and in good faith.

Taking fines, penalties and the reputational harm that comes from an enforcement action off the table would remove a major source of risk and uncertainty for innovators. But consumers would remain protected. Not only would consumers be able to enjoy the fruits of

innovation, but entrepreneurs would compensate consumers for any inadvertent harm suffered in the process. Given the nature of the product and anticipated number of customers, a firm can estimate in advance the potential for consumer harm. By contrast, fines, which are driven by the whims of the regulator, can often dwarf the compensatory damages, and may bear little or no relationship to actual customer harm. For example, in the Wells Fargo scandal dealing with unauthorized accounts, the bank may end up paying only \$5 million in compensation to consumers while it must pay \$185 million in fines.

While fines in addition to customer restitution are appropriate for intentional bad acts, a firm that wants to try a new product to better meet the needs of consumers and acts in good faith doesn't deserve regulators penalizing it or dragging its name through the mud. Without having to worry about outsized and arbitrary risk, firms could pursue innovation with confidence while still being responsible for making customers whole if they are harmed.

Needlessly spurning useful tools based on a misunderstanding of how they would work in practice prevents progress and doesn't protect the public. While consumer protection is vital, it is not incompatible with innovation or providing certainty to companies trying to improve options for the public. Policymakers and regulators should match their rhetoric with action and provide regulators and companies the space they need to build a better future.

*Brian Knight is a senior research fellow in the Financial Markets Working Group with the Mercatus Center at George Mason University.*



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## BankThink Credit markets need legislative guidance after Madden decision

By Brian Knight

Published September 14 2017, 11:40am EDT

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*Editor's note: This post originally appeared in slightly altered form on the FinRegRag blog.*

In a recent op-ed in American Banker (derived from a longer blog post), professor Adam Levitin argues that the recent legislative proposals to "fix" the repercussions of the United States Court of Appeals for the Second Circuit's Madden v. Midland Funding decision are "overly broad and unnecessary and will facilitate predatory lending." The legislation Levitin opposes would restore the ability of banks to sell loans to nonbanks and have the loans remain valid on their original terms, the type of transaction on which the Madden decision has cast doubt. I disagree, at least with regard to marketplace lending. There are compelling legal and policy arguments to undo the Madden decision that Congress should consider. (To be clear, this is not an endorsement of any particular legislation.)

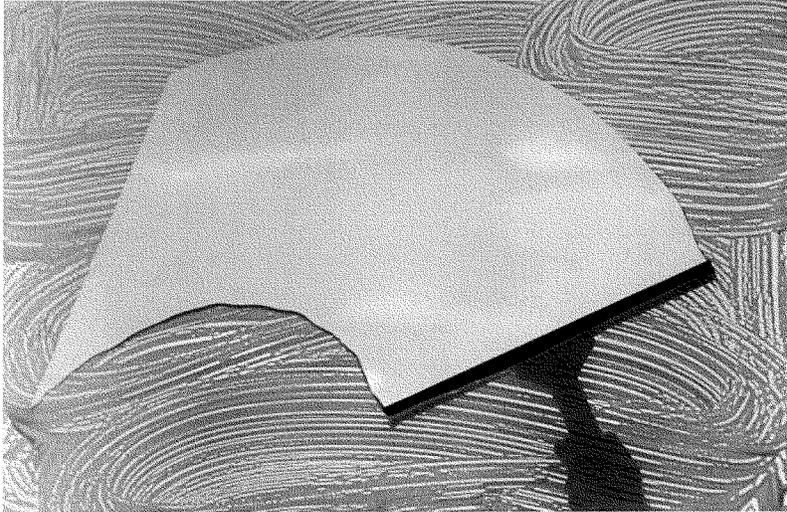
### Applying valid-when-made is appropriate

The text of the Protecting Consumers Access to Credit Act of 2017 states that the principle

that a loan is “valid at inception cannot become usurious upon the subsequent sale or transfer of the loan to another person” has been a cornerstone of banking law, “as provided in the case of *Nichols v. Fearson*”. Levitin argues that supporters of the legislation rely on an incorrect interpretation of “valid-when-made.” Levitin points out that the *Nichols* case, as well as a number of other 19th-century cases dealing with whether “in a string of transactions from X to Y to Z, if X to Y is nonusurious, but Y to Z is usurious, can X shelter in Y’s usury defense[?]” The answer those cases gave was “no.” Levitin considers this a just result because the originator of the note should not get off the hook simply because a subsequent unrelated transaction was usurious.

Levitin argues that the *Madden* case is different. In *Madden*, the ultimate purchaser of the loan (Midland Funding) wanted to take advantage of the state usury law preemption enjoyed by the originator of the loan (the bank). Levitin argues that valid-when-made has nothing to do with the issue in *Madden* and similar arrangements where banks sell loans to nonbanks.

Levitin is certainly right that the *Nichols* case and the similar 19th-century cases reflect a different fact pattern than was presented in *Madden*. It does not necessarily follow, however, that the principle of valid-when-made should not also apply under the *Madden* facts. The drafters of the *Madden* fix bills might have set themselves up for trouble by saying that valid-when-made “as **provided** by *Nichols v. Fearson*” (emphasis added), since that implies that the court created the doctrine, or set out its boundaries in the *Nichols* case. But this isn’t what happened. Instead, the *Nichols* court cited a preexisting maxim and applied it to a certain set of facts. Proponents of the *Madden* fix can’t cite *Nichols* as controlling legal precedent (or else we wouldn’t be having this debate), but that doesn’t mean that the maxim of valid-when-made is limited to the *Nichols* facts or shouldn’t apply in the present case.



Congress should correct the Second Circuit's mistake in *Madden v. Midland Funding* and restore clarity to credit markets and access to borrowers who need it.

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In fact, courts have cited *Nichols* and the principle of valid-when-made in other contexts. Perhaps the most direct example is the case of *FDIC v. Lattimore Land Corp.* In that case, the U.S. Court of Appeals for the Fifth Circuit held that a nonusurious loan made by a nonbank under Georgia law and subsequently transferred to a Tennessee-based national bank did not become usurious, even though it exceeded Tennessee's usury cap, because "[t]he nonusurious character of a note should not change when the note changes hands." The *Lattimore* court cited to *Nichols* for the proposition that:

"If, in its inception, the contract which that instrument purported to evidence was unaffected by usury, it was not invalidated by a subsequent transaction."

This proposition was articulated by the Supreme Court as one of the "cardinal rules in the doctrine of usury."

In *Lattimore*, as well as in *Madden*, the original borrower is trying to assert a usury defense because the loan changed hands. This case is not identical to the issue in *Madden*, because the loan in *Lattimore* went from a nonbank to a bank. As the United States Solicitor General and Office of the Comptroller of the Currency point out, however, there is an "appealing symmetry" to the idea that if valid-when-made applies in the context of a nonbank assigning a loan to a bank, the reverse should also be true.

#### **Applying valid-when-made is just**

There is also a strong argument that applying valid-when-made to cases like *Lattimore* and *Madden* is just. Recall Levitin's argument that X, the original borrower, should not get out of her original and valid contract simply because a usurious transaction happened downstream. In the present case, we have a borrower who took out a legal loan, something happened to the loan downstream (a sale) that did not change the original borrowers' obligations, and now the original borrower wants to use that downstream event to get out of their obligation to repay. Why should the borrower get a windfall because a loan is sold?

Levitin argues that the loan is only valid when *held* by a bank; the loan was actually usurious from the start and the law only stayed the application of the usury laws so long as the loan was held by a bank. This interpretation of the law is not shared by, among others, the solicitor general and the OCC, who argue that the ability of a bank to sell a loan contains the ability to have the loan remain valid on its original terms.

And why should the validity of the loan hinge on who holds it anyway? Levitin argues that banks are subject to an "alternative federal regulatory regime" that does not apply to nonbanks, and therefore nonbanks should not be entitled to the benefits of federal regulation.

However, it is unclear what relevant regulation banks are subject to that nonbanks aren't. The issue at question in Madden, the interest charged on the loan, was set by *the bank* at the loan's inception. The borrower got the benefit of the federal regulatory regime, which includes the incorporation of the bank's home state usury law, when the loan was created, and the relevant characteristics did not change. So why is there suddenly a problem?

Further, Levitin seems to accept that a bank should be allowed to shift the credit risks of the loan off of its portfolio. Why should a bank be allowed to shed risk via securitization (which he acknowledges may be implicated by Madden) or financial engineering but not a direct sale of the loan? Such efforts to shift credit risk would also seem to undo another supposed benefit of Madden, that it forces banks to take greater care underwriting. Banks shifting credit risk off their books, regardless of method, could lower their underwriting standards, but they still face the reality that selling interests in loans that fail to perform will be punished by the market.

Regardless of whether the bank sells the loan, securitizes it, or offers some sort of participation interest, the loan can only ever be what the bank is allowed to offer under its federal regulatory regime (or else it isn't valid). If the loan remains what the borrower, the lender, and the law thought was acceptable when the loan was made, why should a change in ownership of the loan destroy the contract? Contrary to Levitin's assertion, fixing Madden is not about repealing usury laws, it is about making clear that the usury laws applicable to a loan do not change suddenly and arbitrarily.

It is also unclear just how different the relevant law between banks and nonbanks actually is. As the Treasury Department noted, federal consumer protection laws apply equally to marketplace lenders and banks. Both are subject to Dodd-Frank's prohibition against unfair, deceptive, or abusive acts or practices, and the Consumer Financial Protection Bureau has jurisdiction over both. For example, any qualifying loans, whether made in conjunction with a marketplace lender or not, will be subject to the CFPB's anticipated small-dollar rule. Likewise, marketplace lenders who partner with banks are generally subject to examination

and regulation by federal banking regulators under the Bank Service Company Act. There may be differences in how the law treats banks and nonbanks, but that doesn't mean the differences are material. There is a robust federal and state consumer protection regime governing marketplace loans, not a "regulatory vacuum."

Levitin calls for various new requirements for loans, including an ability to repay component, dictating certain loan characteristics other than the interest rate, and a prohibition on forced arbitration. All these requirements are beyond the scope of the laws implicated by Madden. While they may have merit as a matter of policy, that is a separate debate from the question posed by the Madden decision — whether a borrower should be held to the terms of her original contract if her loan is sold.

#### **The impact of Madden on innovative credit is harmful to borrowers**

Levitin argues that there is no policy justification for applying valid-when-made in the aftermath of Madden. However, this isn't true. Besides the question of justice discussed above, Madden also appears, as would be expected, to be reducing access from marketplace lenders to credit for borrowers with lower credit scores. Contrary to Levitin's argument, a recent study shows a reduction in credit availability not just for borrowers with FICO scores under 625 (though that is where the reduction is most pronounced). The study indicates that borrowers in New York and Connecticut with FICO scores under 700 saw a reduction in availability relative to comparable borrowers outside the Second Circuit.

Even if the Madden decision does reduce credit availability, Levitin finds the reduction acceptable; after all, we don't let people "pledge their children and organs as collateral," right? While it might be true that certain access-to-credit-enhancing policies might impose unacceptable costs, fixing Madden does not. The loans in question were societally acceptable to begin with. All fixing Madden does is ensure that the expectation of the borrower, seller, and the law at the time the contract was created are validated. Making people abide by the contracts they legally entered into is hardly the same as pledging a kid

or kidney as collateral.

This hyperbole also ignores the reality that access to credit is often consumer protective. For example, it is important to keep in mind that the majority of marketplace loans are used to pay off bank-issued credit cards (which are not subject to borrower state usury laws) or consolidate existing debt. Denying borrowers access to these loans does not leave the borrowers unencumbered by debt; it leaves them in the situation they view as worse than taking out this new loan. We should not be dismissive of this risk, or throw roadblocks up that prevent borrowers from improving their situation. This is especially true given that there is evidence that marketplace lenders can help provide expanded access and competition, services in areas that have few banks, and better pricing for some borrowers than they would receive from banks. Cutting off access isn't protecting borrowers, it is leaving them with fewer, perhaps inferior, tools to protect themselves.

As Levitin acknowledges, usury caps are crude tools. Interest rate caps impact only part of what determines the cost of a loan. Usury caps can lead to loan arrangements being distorted in ways that make the loans legal but worse for the borrower. We see examples of this in the shift from payday to "payday installment" and subprime auto loans, where lenders bound by interest rate caps change the loan principal amount or repayment schedule to make the loans viable. These loans can actually be more expensive in total because the lower interest rate is applied to a higher principal over a longer time period. Larger loans also can be more expensive for borrowers if they pay them off early or go into default. Borrowers also could be forced into using suboptimal options like pawn shops or illegal loans, or find themselves without credit altogether.

Levitin is right that we don't know if the borrowers being cut off from marketplace loans are finding credit elsewhere. Even if borrowers are finding credit elsewhere, however, we should be concerned that the replacement credit is inferior to the marketplace loans they are being denied. The burden is on those who advocate denying borrowers their first choice to show that the borrower isn't being harmed.

### Madden should not be the end of the discussion

With the expansion of nonbank credit providers, the role of technology, and evolving regulation and consumer preferences, Levitin is absolutely right that the rules of the credit market should be rethought. After all, why should banks have a unique advantage to provide credit nationwide? Rather, lenders offering similar products, posing similar risks, should be held to similar standards. While that discussion absolutely should happen, in the meantime, Congress should correct the Second Circuit's mistake and restore clarity to credit markets and access to borrowers who need it.



### Brian Knight

Brian Knight is senior research fellow in the Financial Markets Working Group with the Mercatus Center at George Mason University.

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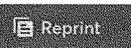
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*GEORGETOWN UNIVERSITY LAW CENTER*

***Adam J. Levitin***  
*Agnes N. Williams Research Professor of Law*

**Written Testimony of**

**Adam J. Levitin**  
**Professor of Law**  
**Georgetown University Law Center**

Before the United States House of Representatives  
Committee on the Financial Services  
Subcommittee on Financial Institutions and Consumer Credit

**“Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace”**

January 30, 2018  
10:00 am  
2128 Rayburn House Office Building

**Witness Background Statement**

**Adam J. Levitin** is the Agnes N. Williams Research Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation, structured finance, contracts, bankruptcy, and commercial law. Among his publications are *Pandora's Digital Box: The Promise and Perils of Digital Wallets*, 166 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 305 (2018).

Professor Levitin has previously served on the Consumer Financial Protection Bureau's Consumer Advisory Board, as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP), and, as relevant to this hearing, as an expert witness for the FDIC in rent-a-bank litigation.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, M.Phil and A.M. degrees from Columbia University, and an A.B. from Harvard College. His scholarship has won numerous prizes, including the American Law Institute's Young Scholar's Medal.

Professor Levitin has not received any federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.<sup>1</sup>

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<sup>1</sup> I would like to thank Julia Dimitriadis for her research assistance with this testimony.

Chairman Leutkemeyer, Ranking Member Clay, Members of the Subcommittee:

Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am the Agnes N. Williams Research Professor of Law at Georgetown University, where I teach courses in financial regulation among other topics. I am here today solely in my academic capacity and am not testifying on behalf of any entity. I'm also pleased that many of the students from my Consumer Finance class are here today to witness the legislative process in action.

The main point I wish to make today is that the term "fintech" covers a broad array of nonbank financial services companies. Some of these companies offer payment services and some credit services. Some compete with banks, and some partner with banks. Many are good actors, but unfortunately some are not. All of this means that different segments of the fintech industry raise different regulatory concerns.

Payment fintechs are currently regulated primarily through a duplicative state-level money transmitter licensing regime. The main concern they raise from a regulatory perspective is the potential loss of customer funds. Payment fintechs would benefit from uniform regulation through the creation of a federal money transmitter license and concomitant insurance regime.

Credit fintechs raise more concerns, most notably in the areas of fair lending and lending without regard to borrowers' ability to repay—that is abusive lending. Fair lending concerns are best addressed through a no-action letter process tied to self-testing, while abusive lending is best addressed in the first instance through state usury and consumer protection laws, although ultimately Congress or the Consumer Financial Protection Bureau, through its existing rulemaking authority, should consider adopting a general ability to repay requirement for all forms of credit.

#### **I. WHAT IS A FINTECH?**

Today's hearing focuses on the appropriate regulatory framework for so-called "fintechs" or financial technology companies. As a starting point, it is important that the terminology used here be clear. The term "fintech" is vague and lacks a precise definition. It is hard to speak in any meaningful way about "fintechs" as a group. The term "fintech" is a rubric used to describe a large range of nonbank financial services companies. Some of these companies offer consumer credit, some payments, some insurance, some investment services, and some financial advice. Some of these companies compete directly with banks, while others partner with banks. Additionally, some fintechs deal directly with consumers, while some provide support services for other financial institutions. Given this Subcommittee's jurisdiction, my testimony today focuses largely on consumer-facing fintechs that deal with credit and payments (including crypto-currencies), although one of my suggestions, relating to the portability of consumer account data, also implicates financial advisory fintechs.

The sheer variety of firms that are called fintechs has an important implication for regulation: because different types of fintechs do very different things, they raise different

types of regulatory concerns and should be addressed differently. Put another way, it might not be very useful to speak about “fintechs” generally when discussing regulatory frameworks. Instead, as a starting point, I think it is helpful to break fintechs into “payment fintechs” and “credit fintechs”. One can make further differentiations within these groups, but payments companies like Venmo, Square, or Zelle raise fundamentally different issues for regulators than credit companies like Quicken Loans, LendUp or Think Financial.

To the extent we can speak of fintechs as a general category, however, they have two distinguishing features. First, fintechs are nonbank financial services companies. In other words, they are marked by what they are not, namely banks. And second, they use some sort of digital technology to provide financial services to consumers. These technologies include web- or mobile-based consumer interfaces, automated underwriting, neural network and other machine-learning-based underwriting, and the use of non-traditional underwriting data sources.<sup>2</sup>

Critically, neither of these features alone makes a firm a fintech. Nonbank financial services companies have been around since time immemorial. Likewise, banks and other well-established players in the financial services industry regularly make use of a range of digital technologies. Fannie Mae and Freddie Mac have been using “automated underwriting” technology (rather than relying on individual loan officer determinations) for over a quarter of a century. Bank credit card issuers have used neural networks for both fraud detection and underwriting decisions for well over a decade.

What’s new here, then, is not so much the use of technology, but that there are a set of new nonbank entrants in the financial services marketplace that are operating across state lines and frequently using the Internet, rather than brick-and-mortar stores or agents, brokers, and correspondents with physical locations, as their mode of consumer interface. Traditionally banks relied on their monopoly of access to the payment system through deposit accounts as a way of obtaining customers for other products—the customer relationship with the depositor enabled the cross-selling for other products. Nonbank finance companies had to maintain brick-and-mortar presences to compete or rely on agents, brokers, and correspondents with physical locations, all of which added to the expense of their products.

The Internet has made it possible for nonbank financial services companies that do not partner with banks to readily acquire customers without the deposit-relationship-based cross-sell. It has also made them more competitive on a cost-basis and facilitated rapid expansion to national operations. Thus, what is new about fintechs is that they are nonbank financial companies with ready ability to acquire consumers because of the Internet.

This means that despite the regular use of buzzwords like “transformative” and “disruptive” in discussions about fintechs, there really isn’t anything particularly transformative or disruptive about them. All fintechs still provide the same basic financial

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<sup>2</sup> The range of technologies used by fintechs is so broad as to make it an almost meaningless characteristic.

services that traditional financial institutions provide: payments, credit, savings and investments, insurance and advice. A mortgage lender or a payday lender that interfaces with consumers over the Internet is still just a mortgage lender or a payday lender. The improvements that fintechs offer are ones on the margins, such as facilitating access to credit for borrowers with thin credit files or enabling faster payments. These are good things, but it is an overstatement to call them “transformative.” While fintechs offer some competition for banks, they often operate in market segments that are not well-served by banks; they are not eating the banks’ lunch yet.

The forgoing definitional discussion is not merely academic. The use of technology by banks has not challenged the adequacy of the current bank regulatory regime. Instead, it is the growth of importance in the financial system of nonbank players that poses the challenge, and this points to the primary issue with fintech regulation being about the adequacy of the current framework for regulation of nonbanks, not the adequacy of regulation of technologies used in financial services.

## **II. FINTECHS: THE GOOD, THE BAD, AND THE UGLY**

Fintechs hold out both promise and perils. Fintechs potentially help increase financial inclusion by making credit accessible to populations not well served by banks such as borrowers with poor credit, small businesses, and millennials. They may make credit available more quickly than traditional lenders, which is generally good for consumers. They expand other consumers’ choices for loans and payments. Fintechs hold out a great deal of promise for helping to serve underserved populations and for creating efficiencies in the consumer financial services space.

Yet it’s also important to understand the risks fintechs pose. Credit-fintechs often lend at high interest rates to consumers whose ability to repay has not been verified. Given that some of these credit fintechs securitize their loans, they have a reduced incentive to ensure that borrowers are in fact able to handle the credit they are given.

Credit-fintechs also sometimes use alternative underwriting data and techniques. The use of non-standard underwriting data and methods can raise the possibility of discriminatory lending, even if it is unintentional, and, to the extent a lender uses neural networks for its underwriting, the lender may not even understand how the underwriting is working. Even payment fintechs pose a risk to consumers—some payment fintechs—those that operate so-called “staged wallets”, such as PayPal and Venmo, allow consumers to maintain a balance on their accounts. These balances are not insured by the FDIC. If the fintech were to fail, consumers could lose their funds and there could be serious economic disruption. It’s also easy to imagine a fintech failing—if one payment fintech were hacked, it could result in a run on other payment fintechs.

### **A. Cautionary Fintech Tale #1: CompuCredit**

The other witnesses today aren’t going to highlight the problems that have arisen with fintechs, so I’m going to point out a pair of cautionary tales. First is the example of CompuCredit. CompuCredit is a nonbank consumer finance company based in Georgia

that specializes in lending to consumers with poor credit—a subprime lender. CompuCredit had an arrangement with three FDIC-insured state banks in which they would issue CompuCredit-branded credit cards to consumers according to CompuCredit’s underwriting guidelines and with CompuCredit’s marketing materials.<sup>3</sup> CompuCredit would within 24 hours purchase all but \$1 million of the receivables on the cards from the banks. In other words, CompuCredit was a fintech operating a classic “rent-a-bank” operation (a transaction type discussed in more detail below in Part III).

CompuCredit also used nontraditional data sources in its underwriting. In addition to standard underwriting elements, such as a FICO score, CompuCredit’s underwriting accounted for particular transactions consumers had undertaken. If a consumer had his tires retreaded, or visited a marriage counselor or a massage parlor, the consumer would find his interest rates increased. CompuCredit did not have algorithms that showed a mathematical relationship between particular transactions and risk.<sup>4</sup> Instead, its underwriting was based on a neural network that identified correlations without being able to express an algorithmic relationship.

The FTC sued CompuCredit for unfair and deceptive acts and practices for failing to disclose this unusual behavior-based underwriting, and the FDIC sued the three banks that rented out their charters for engaging in unsafe and unsound banking practices. The FTC settled with CompuCredit for over \$114 million in consumer relief, and the FDIC settled its suits against the banks that rented out their charters.<sup>5</sup>

CompuCredit was adjusting its pricing based on particular transactions a consumer had undertaken. None of those transactions obviously related to a protected class under the Equal Credit Opportunity Act, but it’s not hard to see how that could easily happen. Imagine if a firm found risk correlations were based on the regular purchase of Goya or Manischewitz products or no-lye relaxer or with one’s college major (computer science, Afro-Am studies, etc.). The underwriting wouldn’t just be creepy; it would likely be illegal. That’s the sort of risk that lies in the use of nontraditional underwriting data.

The point here is not about discriminatory intent, but about discriminatory effects, which may occur unwittingly with algorithmic or neural underwriting. Indeed, if a firm used neural networks for its underwriting, it might not even understand the nature of the

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<sup>3</sup> *In the Matter of CompuCredit Corporation, Atlanta, Georgia*, FDIC Nos. 08-139b and 08-140k (June 10, 2008); *In the Matter of Columbus Bank and Trust Company, Columbus, Georgia*, FDIC Nos. 08-033b and 08-034k (June 9, 2008); *In the Matter of First Bank and Trust, Brookings, South Dakota*, FDIC Nos. 07-228b and 07-260k (June 10, 2008); *In the Matter of First Bank of Delaware, Wilmington, Delaware*, FDIC Nos. 07-256b and 07-257k (June 10, 2008).

<sup>4</sup> Complaint at 34-35, *Federal Trade Commission v. CompuCredit Corporation and Jefferson Capital Systems, LLC*, 2008 WL 8762850 (N.D. Ga.) (FTC No. 062-3212).

<sup>5</sup> Press Release, FDIC, *FDIC Announces \$114 Million Settlement With Subprime Credit Card Company Charged With Deceptive Credit Card Marketing* (December 19, 2008); Press Release, FTC, *Subprime Credit Card Marketer to Provide At Least \$114 Million in Consumer Redress to Settle FTC Charges of Deceptive Conduct* (December 19, 2008); Press Release, FDIC, *FDIC Seeks in Excess of \$200 Million Against Credit Card Company and Two Banks for Deceptive Credit Card Marketing* (June 10, 2008).

correlations being found through the machine learning process, but fair lending requirements look at effect, not intent.

### **B. Cautionary Fintech Tale #2: Mt. Gox**

The second cautionary tale is that of Mt. Gox, a failed bitcoin exchange and clearinghouse. Mt. Gox was at one point the largest bitcoin intermediary in the world. In this regard, it was a payments fintech, much in the way PayPal stands between the ultimate buyer and seller of goods. In February 2014, Mt. Gox filed for bankruptcy, saying that because of a hacking it had “lost” something in the range of 7% of all bitcoins. Mt. Gox customers are still trying to get their bitcoins back. Something as pedestrian as a hacking can bring down a payment fintech very rapidly, and without adequate insurance requirements for such fintechs, consumers stand to lose their funds.

My point here is not to argue that fintechs are good or bad. Instead, it’s to emphasize that they have both promise and perils, and any regulatory framework needs to account for both, facilitating the good work that fintechs can do, while also protecting against the harms they can wreak.

### **III. BANK PARTNERSHIPS WITH FINTECHS**

While some fintechs compete against banks, others partner with banks. Partnerships between banks and fintechs tend to be either payment-fintech partnerships with large banks or credit-fintech partnerships with small banks. Yet it is important to recognize that few banks overall engage in partnerships with credit-fintechs, and only a handful of community banks partner in any way with fintechs.

Bank-fintech partnerships raise a unique set of concerns, both in terms of safety-and-soundness for the banks and in terms of consumer protection. Some bank partnerships with fintechs involve payments, and these relationships expose banks to reputational risk if the fintech has operational problems and potentially to credit losses if customer funds are lost (which the bank would likely have to cover under the Electronic Funds Transfers Act, 15 U.S.C. § 1693h).

More commonly, bank-fintech partnerships are with credit fintechs and involve “rent-a-bank” relationships. In a rent-a-bank transaction, the loans will be originated by a bank according to guidelines set by the marketplace lender or payday lender. The loans are then sold almost immediately to the marketplace lender or payday lender under a standing agreement to purchase all or almost all such loans. The loan disbursement will generally be by the bank in this sort of arrangement, and loan payments might in fact be made to the bank, but the bank is not the real economic party in interest nor is it exercising meaningful control over the design of the loan product. The point of this sort of rent-a-bank transaction is for the nonbank fintech to avoid the application of state usury laws by sheltering in federal law’s preemption for banks of usury laws and certain other consumer protection laws.

It’s hard to call this anything other than “loan laundering.” Federal regulators have long frowned on this sort of arrangement, but it is important to emphasize that there

are no actual prohibitions against it.<sup>6</sup> Instead, there is only non-binding regulatory guidance. Moreover, the level of supervision of bank-fintech partnerships is discretionary and quite likely to vary by Administration. Thus, while Mr. Smith characterizes regulatory supervision of bank partnerships with fintechs as “rigorous,” there is reason to doubt that it will continue to be so under the current Administration, as indicated by the CFPB (now under the control of a Trump Administration appointee) recently dropping its suit against several affiliated Internet payday lenders—fintechs that were engaged in a rent-a-tribe scheme (involving an attempt to shelter in tribal sovereignty against state usury laws, rather than National Bank Act or Federal Deposit Insurance Act preemption).

Rent-a-bank transactions pose both safety-and-soundness and consumer protection concerns. From a safety-and-soundness perspective, there is the danger that the fintech fails to honor its obligation to purchase the loans made by the bank. If so, the bank is stuck with a bunch of loans that it would never have made on its own—the loans present a risk profile with which the bank is not comfortable; were it otherwise, the bank wouldn’t bother partnering with the fintech, but would just make the loans itself. For a small bank, the exposures can be material. Moreover, the bank is exposed to the reputational risk that comes with partnering with the fintech, particularly if the fintech services the loan and handles collections. Aggressive collections tactics by the fintech might harm the bank’s reputation.

The consumer protection concerns from rent-a-bank operations are more serious. The *sole* purpose of a rent-a-bank transaction structure is the evasion of state usury and consumer protection laws. Congress has exempted national banks and federally insured state-chartered banks from the application of state usury laws. But this exemption does not exist in a void. It is part and parcel of an extensive federal regulatory regime for banks. Rent-a-bank transactions, in contrast, create an abominable regulatory vacuum: the nonbank partner purports to receive the benefits of federal preemption without being subject to the concomitant federal regulatory scheme.

I want to emphasize that most depositories are careful not to abuse third party relationships and would not even contemplate engaging in a rent-a-bank transaction. The handful of banks that do so are very much exceptions in the industry. Protecting rent-a-bank transactions is only in the interest of a handful of bad actors in the banking space.

It is in this context that two bills have been introduced that would, unfortunately, facilitate rent-a-bank schemes. These bills are H.R. 4439, the “Modernizing Credit Opportunities Act” (also known as the “Deemed Lender” bill) and H.R. 3299, the “Protecting Consumers Access to Credit Act of 2017” (also known as the “Madden Fix” bill). Both bills are misguided and would ultimately be harmful to consumers and the safety-and-soundness of the banking system.

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<sup>6</sup> See, e.g., FDIC, Guidance for Managing Third-Party Risk, FIL-44-2008 (June 6, 2008); OCC Risk Management Guidance: Third Party Relationships, OCC Bulletin 2013-29 (Oct. 30, 2013).

### **A. The Modernizing Credit Opportunities Act, H.R. 4439**

When confronted with rent-a-bank situations, courts have often focused on the economic realities of the transaction and looked to see which party is the “true lender” on the loan. If the true lender is not a bank or a native tribe, then that party is not able to shelter in federal preemption for the bank or tribal sovereignty.

H.R. 4439 would instruct courts to disregard economic realities and instead adhere to a legal fiction that the bank is the true lender simply because it is the originator of the loan. This is a terrible idea. “True lender” doctrine is an important doctrinal tool to police against abuses of the banking system. It’s disgraceful that Congress would attempt to protect sham transactions, yet that is precisely what H.R. 4439 does. It deems the bank to be the true lender in a transaction no matter what the underlying facts and circumstances are.<sup>7</sup>

Thus, under H.R. 4439, even if a nonbank were to dictate the underwriting and marketing terms of a loan and assume 100% of the risk on the loan and handle the servicing of the loan, the bank would still be deemed the lender for purposes of preemption of state usury laws. The facts that the bank might formally fund the loan and that payments are made to the bank are irrelevant—the funding is indirectly coming from the fintech and all payments received are being remitted to the fintech.

It is true, as Mr. Smith notes in his written testimony, that because true lender doctrine is a standard that looks at the totality of facts and circumstances that it can complicate transaction planning. But good lawyers will have no trouble advising their clients about how to avoid running afoul of the doctrine. Lawyers advise clients in the shadow of standards based regimes all the time; every state has an unfair and deceptive acts and practices (UDAP) statute, and there are also federal UDAP and UDAAP (unfair, deceptive, and abusive acts and practices) statutes.<sup>8</sup> The mere fact that there is a standards-based doctrine is not grounds for legislative intervention, much less the particular intervention contemplated by H.R. 4439. The fact that true lender doctrine is a standard, not a rule, is only a problem for those financial institutions that want to “push the envelope,” and that’s exactly how it should be. H.R. 4439 encourages predatory lenders to “push the envelope,” and that’s an outrage.

### **B. The Protecting Consumers Access to Credit Act of 2017, H.R. 3299**

H.R. 3299 has been voted out of committee. Nevertheless, I think it is important to put into the record for the consideration of the full House the serious flaws of the bill. H.R. 3299 is a response to a court ruling called *Madden v. Midland Funding, LLC*.<sup>9</sup> *Madden* held that National Bank Act preemption of state usury laws did not apply to a loan that had been made by a national bank once the loan had been sold (post-default) to a debt buyer.

<sup>7</sup> It’s also unclear what H.R. 4439 has to do with financial “innovation.” Usurious lending is as old as recorded human history, and sham transactions such as “dry exchange” that attempt to circumvent usury prohibitions are well-documented by the Middle Ages.

<sup>8</sup> 12 U.S.C. §§ 5531, 5536; 15 U.S.C. § 45(a).

<sup>9</sup> 786 F.3d 246 (2d Cir. 2015), cert. denied, 136 S. Ct. 2505 (2016).

The *Madden* decision caused consternation in four distinct parts of the consumer finance industry: debt buyers, securitizers, marketplace lenders, and payday lenders. *Madden's* application to debt buyers is clear enough. Securitization of consumer debts involves the transfer (and typically the repeated transfer) of the debts from the originating entity (such as a national bank) to a nonbank securitization entity that holds the debts and issues securities against them. Marketplace lenders and payday lenders will sometimes originate loans themselves, but they will also sometimes engage in rent-a-bank transactions.

H.R. 3299 would effectively overturn the *Madden* decision and provide that a loan that was “valid” with respect to usury laws when the loan was made would continue to be valid even after a subsequent assignment.<sup>10</sup> In so doing, H.R. 3299 purports to restore the “valid when made” legal doctrine that it claims is a:

cornerstone of United States banking law for over 200 years, as provided in the case *Nichols v. Fearson*, 32 U.S. (7 Pet.) 103, 106 (1833), where the Supreme Court famously declared: “Yet the rule of law is everywhere acknowledged, that a contract free from usury in its inception, shall not be invalidated by any subsequent usurious transactions upon it.”<sup>11</sup>

H.R. 3299 also claims to stand on a scholarly study that concluded that “the *Madden v. Midland* decision has already disproportionately affected low- and moderate-income individuals in the United States with lower FICO scores”.<sup>12</sup>

Both of these statements are incorrect. Moreover, there is no evidence whatsoever to support the bill’s claim that “if the valid-when-made doctrine is not reaffirmed soon by Congress, the lack of access to safe and affordable financial services will force households in the United States with the fewest resources to seek financial products that are nontransparent, fail to inform consumers about the terms of credit available, and do not comply with State and Federal laws (including regulations).”<sup>13</sup>

***1. The “Valid-When-Made” Doctrine Is a Modern Invention, Not a “Cornerstone” of US Banking Law.***

Whatever the merits of the so-called “valid when made” doctrine, it is *not* a cornerstone of US banking law now, nor has it ever been. It has not existed for 200 years, but is instead a very recent fabrication with scant support in law. H.R. 3299 is not restoring the law to its long-existing state, but is, in fact, radically changing it.

As an initial matter, the valid-when-made doctrine could not be 200 years old because it involves an issue that could not have arisen prior to the 1864 National Bank Act. Prior to the National Bank Act, state usury laws applied to all entities equally. There were no classes of entities such as national banks that were exempt from state usury laws. Thus, prior to 1864, it was not possible for a loan to be non-usurious in the hands of an original lender and subsequently become usurious in the hands of an assignee simply on the basis of

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<sup>10</sup> H.R. 3299, § 3.

<sup>11</sup> H.R. 3299, § 2(2).

<sup>12</sup> H.R. 3299, § 2(5).

<sup>13</sup> H.R. 3299, § 2(6).

the assignment. This alone should cast doubt on the claims of a historical “valid-when-made” doctrine.

Even with extensive research, I have been unable to identify any case prior to the late 20<sup>th</sup> century that deals with the question of whether the usurious character of a loan changes merely by fact of the loan’s assignment. The “valid when made” issue was simply never a question, so it could not have been a doctrine.

The 1833 Supreme Court case cited in H.R. 3299, *Nichols v. Fearson*, pre-dates the National Bank Act, which should already make us suspect of its relevance to the issue of “valid when made.” More critically, though, *Nichols* did not in any way announce a doctrine that means that a loan if not usurious when made can never subsequently be usurious.<sup>14</sup> Instead, *Nichols* says that a valid contract cannot become usurious by a “subsequent usurious transaction” (emphasis added).<sup>15</sup> The distinction is critical for understanding the doctrinal point in *Nichols*, which is that usury in transaction #2 does not affect transaction #1.

*Nichols* involved a valid note for \$101 payable to the defendant. The defendant subsequently indorsed and sold the note to the plaintiff for \$97.<sup>16</sup> The discount from the face value of the note was treated as implied interest—just as original issue discount on a security is treated today as interest for tax or bankruptcy claim calculation purposes. When the maker of the note refused to pay, the plaintiff sued the defendant on its indorsement of the note (indorsement made the indorser liable for the note). The defendant claimed that the note was void on account of the usurious discounting, but the Supreme Court disagreed, noting that the usurious discounting did not void the original note and were the rule otherwise, the indorser would escape liability on its indorsement.

*Nichols*, then, does not stand for any sort of “valid when made” doctrine. Instead, it stands for a narrower principle that a non-usurious transaction is not invalidated by a subsequent and separate usurious transaction. In other words, usurious transaction #2 does not infect valid transaction #1. That’s a totally different legal principle than H.R. 3299 claims *Nichols* represents.

This interpretation of *Nichols* as standing for the principle that usury in a separate, later transaction does not affect the validity of a prior transaction is borne out in every 19<sup>th</sup> century treatise on usury published in America or the United Kingdom. Thus, Webb’s 1899 usury treatise observes that:

A contract, free from usury at its execution, cannot be rendered invalid by any subsequent usurious agreement between the same or other persons. A subsequent agreement may be usurious in itself and thereby become either

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<sup>14</sup> I will refrain from commenting on H.R. 3299’s claim that the Supreme Court made any sort of “famous” declaration in this entirely forgotten case. Cf. Pete Wells, *As Not Seen on TV: Restaurant Review of Guy American Kitchen & Bar in Times Square*, N.Y. TIMES, Nov. 13, 2012 (“What exactly about a small salad with four or five miniature croutons makes Guy’s Famous Big Bite Caesar (a) big (b) famous or (c) Guy’s, in any meaningful sense?”).

<sup>15</sup> 32 U.S. at 109.

<sup>16</sup> 32 U.S. at 103.

wholly or partly nugatory; but its fate cannot be visited upon the original valid contract.<sup>17</sup>

To the extent there was ever a historical “valid when made” doctrine it has no relation to the one claimed by H.R. 3299, but instead meant that if transaction #2 was usurious, there was no infection of transaction #1. There is no historical pedigree for the “valid when made” doctrine claimed by H.R. 3299. It’s a modern invention.

## ***2. The Invented “Valid-When-Made” Doctrine Is Nonsensical Because Preemption Is Not Assignable***

Putting aside the valid-when-made doctrine’s suspect pedigree, it makes no sense as a doctrinal matter. The idea that federal preemption would follow a loan is itself nonsensical. National Bank Act or Federal Deposit Insurance Act preemption is not a *property right*, but a *status* that goes with being a national bank or a federally insured state bank. The common law of assignments covers only property interests. It does not cover inalienable status, such as personal privileges or statutory status. Thus, a building that has been grandfathered in to current zoning can be sold with the grandfathering rights because those rights relate to the specific property itself. But an assignor that receives favorable tax treatment on an asset cannot transfer that tax treatment with the asset. The tax treatment is personal to the assignor; it is not a characteristic of the asset.

To give additional illustrations of this point, a diplomat has broad immunity for torts, including those committed with a car. When a diplomat sells his car, the buyer does not acquire diplomatic immunity for torts committed with the car. Likewise, if a diplomat were to commit a crime on behalf of a non-diplomat third party, that third party could not shelter in diplomatic immunity because diplomatic immunity is a non-transferable status. Similarly, the sale of a medical practice does not transfer the right to practice medicine in a state. That is a personal privilege of a medical licensee—it is not a property characteristic of assets of the medical practice. And it is obvious that the sale of loans by a bank does not transfer with it the bank’s FDIC insurance coverage or banking charter.

Preemption of state usury laws is a right that goes with FDIC insurance coverage under the Federal Deposit Insurance Act or with a national bank’s charter under the National Bank Act. Preemption is part of a bundle of regulatory burdens and privileges under these statutes, and it cannot be unbundled and freely alienated as a type of property; preemption is an *in personam* defense or immunity, it is not an *in rem* feature of the loan. The idea that preemption would be assignable makes little sense as a policy matter. National banks and insured state banks are not subject to certain state laws because they are subject to an alternative federal regulatory regime. An assignee of a national bank or insured state bank is not subject to those regulatory regimes, however. Therefore, it should not get that regime’s benefit of preemption of state law lest there be a regulatory vacuum.

The valid-when-made doctrine also makes sense given that the National Bank Act and Federal Deposit Insurance Act do not void state usury laws. Instead, these federal

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<sup>17</sup> JAMES AVERY WEBB, *A TREATISE ON THE LAW OF USURY, AND INCIDENTALY, OF INTEREST* 344 (1899).

statutes merely forestall the application of those usury laws to particular entities; there is no debate that the state usury laws would apply to nonbanks that directly originate loans. The implication is a national bank or state-insured bank can in fact make a usurious loan, but the state usury law will not have any effect on the bank because of the bank's privilege under federal law. The loan's rate still exceeds that allowed under the state usury law, so when the loan parts from the bank, it is no different from any other usurious loan. Rather than the point being "valid when made," it is "Once usury, always usury".<sup>18</sup>

### **3. *There Is No Evidence that the Madden Ruling Harms Consumers***

Third, contrary to the claims of H.R. 3299, there is no evidence that the *Madden* ruling has harmed consumers or that it will result in their substituting less-regulated credit for more-regulated credit. The sole evidence we have on the effect of the ruling is an unpublished study that relies on private data from a single, unidentified marketplace lender. The study seems to indicate that there was a reduction in lending by this single lender to consumers with very low FICO scores, even as lending to consumers with higher FICO scores increased. Critically, the study does not indicate the total dollar amount of the credit contraction to low FICO score borrowers. We cannot tell if it was a material amount or not. More importantly, we cannot tell if this apparent reduction in lending was offset by increased lending from other sources, much less the terms of the lending. We simply do not know the net effect of *Madden* on credit markets.

In the summer of 2017, I was eager to understand more about the study and inquired with the authors of the study both via email and in person about the extent of the credit reduction indicated in the study. The authors explained to me that they could not provide an answer because they are restricted from sharing the underlying data under a nondisclosure agreement with the lender. This is not standard operating procedure for empirical scholarship because it prevents other scholars from checking the work and raising questions about assumptions and attempting to cut the data in different ways that might answer questions differently. Empirical studies should be replicable, and this one is not because of the limitations on data sharing.

I do not say this to in any way impugn the authors of the study, whom I greatly respect. Rather, I say this to emphasize that the study cited by H.R. 3299 is not a basis for what is in fact a radical policy move. Indeed, none of the authors of the study cited by H.R. 3299 have endorsed the bill, in part because they understand that their study does not answer the key question about net consumer welfare. It might well be that the *Madden* decision resulted in reduced lending by *one* lender, but that other lenders filled the void. Ultimately we do not know what happened with the *total* volume of consumer lending and the terms of that lending. Until we do, it would be reckless to legislate a change to the decision. The American financial system has operated just fine without the

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<sup>18</sup> *Id.* 346-47.

valid-when-made doctrine and continues to do so. There's simply no need for H.R. 3299.<sup>19</sup>

More generally, H.R. 3299 and H.R. 4439 make the mistake of confusing “easy” credit with “beneficial” credit. Credit is a two-edged sword. Access to credit can be tremendously valuable for consumers, but only if that credit is affordable and sustainable. State legislatures have, in their wisdom, determined that there are certain limitations on credit terms that are proxies for whether credit is likely to be beneficial rather than harmful. Those are not determinations that Congress should blithely override through bills like H.R. 3299 and H.R. 4439. If Congress believes that state usury laws and other consumer protection laws are bad idea, it should override them plainly and directly, rather than through an obfuscation such as pretending to restore a made-up legal doctrine.

***4. H.R. 3299 Is Overbroad and Facilitates Not Just Marketplace Lending, but Unrestricted Payday Lending***

The proponents of H.R. 3299 emphasize its importance for so-called “marketplace” lenders. It is critical to recognize, however, that H.R. 3299 does not distinguish between marketplace lenders and payday lenders and debt buyers, and would protect them all. H.R. 3299 would facilitate not just marketplace lending, but also payday lending, and not just payday lending generally, but payday lending without *any* restrictions on interest rates, something that no state currently permits. Payday lending is only permitted or feasible currently in only around half of the states, but all of those states impose limits on the rates and terms payday lenders can charge. Under H.R. 3299, a lender with a rent-a-bank or rent-a-tribe relationship would not have to comply with any state restrictions on payday lending. H.R. 3299, then, represents a radical deregulation of consumer credit markets beyond anything that any state has been willing to allow in terms of payday lending. As consumer credit policy goes, H.R. 3299 is “pushing the envelope.”

**IV. THE FINTECH REGULATORY FRAMEWORK**

**A. The Current Regulatory Regime for Nonbank Consumer Finance Companies**

Currently, nonbank consumer finance companies are regulated on both the state and federal levels. Nonbank consumer finance companies are required to be chartered and licensed by states. State licensing regimes are not reciprocal, so a company needs a license for every state in which it operates. The requirements for obtaining a license vary by state and by the particular type of license involved. Different state licenses allow for different types of activities. For example, a lender in Illinois is required to choose between a Consumer Installment Loan Act license and a Payday Loan Reform Act license, each of which permit different types of loans. Beyond licensing, states have different supervision regimes, different substantive laws, and different enforcement policies. All of this means

<sup>19</sup> The argument that *Madden* will result to a shift to less regulated credit is also hollow. The type of credit that is most at risk from *Madden* is rent-a-bank lending, whether by marketplace lenders or payday lenders. The whole point of rent-a-bank lending is that it avoids regulation.

that there are increased regulatory burdens for nonbank financial services companies that operate in multiple states.

In addition to state regulation, virtually all nonbank consumer finance companies are regulated by the Consumer Financial Protection Bureau. The CFPB has rulemaking and enforcement authority over all of these companies and exercises supervisory authority over some of them (primarily mortgage lenders and payday lenders). CFPB regulation provides a modicum of consistency in regulation for nonbank consumer finance companies. Moreover, the CFPB is charged with ensuring that it enforces federal consumer financial law “consistently, without regard to the status of a person as a depository institution, in order to promote fair competition.”<sup>20</sup>

Additionally, prudential bank regulators exercise supervisory authority over bank partnerships with fintechs. Yet it is critical to recognize that regulation in this space is almost all informal and non-binding, except to the extent that the CFPB has UDAAP rulemaking and enforcement jurisdiction over fintech partners of banks that qualify as “service providers” under the Consumer Financial Protection Act. Finally, the Department of Justice and Department of Housing and Urban Development have authority over the Fair Housing Act, which covers both mortgage lending and rentals.

#### **B. Issues with the Current Fintech Regulatory Framework**

There is no acute crisis with the current fintech regulatory framework. It might be less than ideal, but so too is the general structure of US financial regulation. Fintechs have been able to blossom and prosper under the current regulatory regime. What this means is that Congress should proceed deliberately and carefully in making changes to the fintech regulatory framework, with the first principle being “do no harm.”

None of this is to say that the current fintech regulatory framework does not have issues. But the issues posed by the existing regulatory framework vary depending on what a fintech does. For fintechs that are payments processors, the key issue with the current regulatory regime is that they need 50+ state money transmitter licenses to operate on a national scale. Many of them operate this way currently, but dealing with 50+ regulatory regimes certainly poses a hassle. Critically, for payments fintechs, the issue is about the number of regulatory regimes, rather than their substantive terms.

In contrast, fintechs that engage in consumer lending are concerned less about a multiplicity of licensing regimes than about the substantive terms of state law, particularly state usury laws and other consumer protection laws. These laws restrict the terms on which they can lend. Additionally, to the extent credit-fintechs use nontraditional data sources, there are concerns about liability under the Equal Credit Opportunity Act and (if mortgage lenders) under the Fair Housing Act.

#### **C. Suggestions for Fintech Regulation Going Forward**

Based on the forgoing analysis, I would make six concrete suggestions to the Subcommittee regarding fintech regulation going forward.

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<sup>20</sup> 12 U.S.C. § 5511(b)(4).

**(1) Create a federal money transmitter license.** State money transmitter laws date back to the days when Wells Fargo actually operated a stagecoach and the federal government played a minimal role in financial regulation. There's no good case for maintaining state-specific money transmitter regulation particularly given the number of large, national money transmitters. There's no obvious benefit from the 50-state regime, as the substantive requirements are materially similar. Money transmitters that operate nationally merely end up complying with the strictest of regimes. A federal money transmitter license, coupled with some sort of federal insurance for funds held by money transmitters (such as balances in a PayPal or Venmo account) would be a simple move that would help reduce unnecessary regulatory burdens.

Such a federal money transmitter license should be created by statute, as it is questionable whether any existing regulators have authority to issue such a charter. I would urge that the chartering authority—and the concomitant insurance and regulatory regime—be placed with the FDIC. I would also suggest that any such charter not include cryptocurrency institutions, at least initially.

**(2) Facilitate portability of consumer account data.** One of the major problems in consumer finance is the stickiness of consumer financial relations. Consumers do not switch financial service providers nearly as often as they should. Financial institutions know this, and they know it means that they can extract supracompetitive profits from customers.

There are several reasons for the stickiness of consumer financial relations.<sup>21</sup> The first are the search costs of finding a new and better financial relationship. Consumer financial products are fundamentally commodity products, but financial institutions make great efforts to facially differentiate products and make comparison-shopping difficult. All of this increases search costs, and there is no guaranty that a search will be successful. Second, there are unavoidable transaction costs to establishing a new financial relationship such as account-opening paperwork for both internal administrative needs of the financial institution and for compliance with anti-money laundering regulations. Third, there are the costs to switching relationships. For example, direct deposit and automatic bill pay services, although very helpful for consumers, increase switching costs because of the potential disruption to the consumer's payments. Fourth, to the extent that consumers care about physical locations of financial services, there may in fact be few convenient choices available because of entry restrictions in the depository market. And fifth, consumer psychology contributes to a degree of stasis (some of which is rational for the other reasons, but some of which may not be).

One way the consumer financial marketplace could be made more efficient is through facilitating the portability of consumer account data. Financial institutions will generally claim that they "own" the data on a consumer account, such that the consumer cannot freely transfer that data—transaction histories, etc.—to other financial institutions. Quite frequently, it is fintechs that want access to consumer data. These fintechs are

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<sup>21</sup> See, e.g., K. Jeremy Ko & Yoon-Ho Alex Lee, *Consumer Mistakes in the Mortgage Market: Choosing Unwisely Versus Not Switching Wisely*, 14 U. PA. BUS. L.J. 417 (2012).

sometimes financial advisors, rather than direct competitors with the banks, but their advisory services might include advice for a consumer to change a banking relationship. Not surprisingly, banks are not always eager to share consumer data.

The CFPB under former Director Cordray put forth a set of principles on the sharing and portability of consumer data.<sup>22</sup> Those principles are non-binding, but are a starting point for achieving a policy that facilitates consumer data portability without creating undue fraud risks for banks. Congress should encourage regulators to press for greater data portability, and, if the issue cannot be resolved informally, Congress should consider legislation that enables greater data portability rights for consumers.<sup>23</sup>

**(3) Do not create a federal fintech charter for credit-granting institutions unless such institutions (a) are subject to federal consumer protection laws that are at least as protective as the most protective state law regimes and (b) are required to operate on a level playing field with depositories.** While there is a strong case for federal licensing of money transmitters, there is not such a case for federal licensing of non-bank lenders. Nonbank lenders' interest in federal chartering is virtually entirely about avoiding state consumer protection laws. If a federal charter did not come with preemption benefits, there would be no interest in such a charter.

Federal chartering should not be a move to eviscerate state consumer protection laws. Federally chartered institutions should be held to a *higher* standard than state chartered institutions. A federal charter is an unusual privilege for any business, and it should be paired with expectations that the charter holder will act to benefit the commonwealth, which means treating consumers (that is taxpayers) fairly and honestly in all dealings. At the very least, a federal charter should be paired with a general ability to repay requirement for all lending (with administrable safe harbors for fully amortizing loans under a specific interest rate), a positive amortization requirement, and restrictions on rollovers on short-term loans.

Any sort of federal charter for nonbank financial institutions must also maintain competitive parity with depositories. That means that nonbanks should be subject to some form of capital and liquidity regulation, as well as Community Reinvestment Act obligations.

**(4) Consider adopting a general federal "ability to repay" requirement for all forms of consumer credit excluding student loans.** Currently, federal law has statutory ability to repay requirements for mortgage loans and credit card loans. Additionally, the CFPB's Payday Rule creates an ability to repay requirement for certain payday and vehicle title loans. I would urge the Subcommittee (and the CFPB) to

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<sup>22</sup> CFPB, *Consumer Protection Principles: Consumer-Authorized Financial Data Sharing and Aggregation*, Oct. 18, 2017, [http://files.consumerfinance.gov/f/documents/cfpb\\_consumer-protection-principles\\_data-aggregation.pdf](http://files.consumerfinance.gov/f/documents/cfpb_consumer-protection-principles_data-aggregation.pdf).

<sup>23</sup> A related issue is the need to encourage the use of open APIs to ensure interoperability of different institutions' technology platforms.

consider a general ability to repay requirement for all consumer credit other than student loans.

In the traditional lender-borrower relationships, lenders and borrowers were essentially partners—the lender would only make money if the borrower repaid, so the lender was incentivized to ensure that the borrower did not receive more credit than he or she could handle. This traditional partnership model of lending has been replaced in many parts of the consumer finance market.

First, many lenders securitize their loans, so the repayment risk is not held by the party that makes the lending decision. Because securitizers receive payment for the loans upfront, they may be incentivized to increase lending volume at the expense of sustainability of loans.

Second, some lenders have adopted a “sweatbox” model of lending, in which the interest and fees on loans are so high that they will offset any loss of principal if the loan performs long enough; even if the borrower defaults prior to maturity, the lender can still make money. In such a situation, a lender may be incentivized to increase its volume of loans at the expense of a higher default rate.

Third, to the extent that a lender can upsell a consumer (e.g., an auto dealer selling the consumer the “TruCoat”<sup>24</sup> finishing or rustproofing at a huge markup), a loan may be a loss-leader, such that the lender may be willing to incur more defaults because those defaults may be offset by other purchases or transactions with the consumer.

Fourth, loan officer incentives may encourage extensions of credit beyond what is in the interest of the lender institutionally. The clearest case of this is the Wells Fargo fake account scandal. Wells Fargo created incentives that encouraged its employees to open up fake credit card accounts for consumers that resulted in fraudulent card use, and Wells Fargo incurred some of the losses from this fraud.

All of this suggests that lenders cannot be relied upon to consistently ensure that they do not extend credit beyond borrowers’ ability to repay. Overlending to a borrower may actually be in a lender’s economic interest. But it is hardly in the borrower’s interest, and this is where a general regulatory standard such as an ability-to-repay requirement would be helpful. Such a requirement could be made more administrable through regulatory safe harbors along the lines of what the CFPB has done in its Payday Rule. Ultimately, this approach would enable uniform federal regulation of the consumer credit industry, rather than state specific usury and term regulation.

**(5) Encourage federal regulatory agencies to use time-limited no-action letters for the use of underwriting with non-traditional data.** Nontraditional underwriting data potentially expands access to credit to underserved populations, particularly the millions of Americans with thin or non-existent credit files with the three major consumer reporting agencies. The use of such nontraditional underwriting data is potentially beneficial, but also poses the risk of discriminatory impacts in lending. Currently, the Equal Credit Opportunity Act and Fair Housing Act allow

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<sup>24</sup> See FARGO (1996).

lenders to “self-test” without being subject to discovery in litigation for their self-testing results.<sup>25</sup> The idea behind self-testing is that it allows lenders to discover unintentional discrimination and change their practices, but self-testing is not a waiver of liability, even though corrective behavior by a lender is likely to be considered as a mitigating factor in public enforcement.

The use of nontraditional underwriting data could be further facilitated through time-limited no-action letters conditioned upon self-testing by the recipient lender (and reporting of the results to regulators). The individualized no-action letter process would ensure that responsible lenders could experiment with using nontraditional underwriting data without incurring liability for unintentional discriminatory effects. I prefer this no-action letter approach to a broader “sandbox” approach because it is more individually crafted, enabling an upfront consideration by regulators of the firm and data involved, rather than being an open playground. There is currently regulatory authority to issue such no-action letters, but their use has been quite limited to date and should be encouraged. Further, regulators should be encouraged to coordinate their no action processes through the Federal Financial Institutions Examination Council.

**(6) Require the CFPB to fulfill its mandate under section 1071 of the Dodd-Frank Act to collect data on small business lending.** An important segment of credit fintechs are so-called “marketplace lenders.” It appears that a large percentage of marketplace lending is in fact small business lending, even if it is formally lending to individuals, not businesses. A great deal of marketplace lending is in fact small business lending.<sup>26</sup> Unfortunately, regulators lack a good view of what is happening in this market. The CFPB is charged under the Dodd-Frank Act with collecting data on small business lending.<sup>27</sup> To date, however, the CFPB has not implemented this data collection. Absent data, it is difficult to craft good regulatory policy on small business lending, much less ensuring that the market is not plagued by discriminatory lending.

#### **CONCLUSION**

Fintechs hold out both the promise of improved financial services for consumers and risks for consumers and the safety-and-soundness of the financial system. The particularly regulatory issues raised vary by the type of fintech involved, but these risks can be managed through appropriate regulation by both federal and state governments.

#### **Attachments:**

Adam J. Levitin, “*Madden Fix*” Bills Are a Recipe for Predatory Lending, AM. BANKER, Aug. 28, 2017.

<sup>25</sup> 15 U.S.C. § 1691c-1 (Equal Credit Opportunity Act); 42 U.S.C. § 3614-1 (Fair Housing Act).

<sup>26</sup> Jared Bennett, *Is Congress expanding credit for the poor or enabling high-interest lenders?*, The Center for Public Integrity (last updated January 12, 2017, 11:20 AM), <https://www.publicintegrity.org/2017/12/22/21441/congress-expanding-credit-poor-or-enabling-high-interest-lenders>.

<sup>27</sup> 15 U.S.C. § 1691c-2.



## BankThink 'Madden fix' bills are a recipe for predatory lending

By Adam J. Levitin

Published August 28 2017, 10:24am EDT

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*Editor's note: This is an altered version of a post that originally appeared on the Credit Slips blog.*

Currently pending in both houses of Congress are versions of the Protecting Consumers Access to Credit Act of 2017 — bills that would "fix" the 2015 appellate court decision in *Madden v. Midland Funding LLC*. Unfortunately, these so-called legislative solutions are based on a faulty reading of case law.

The *Madden* case held that National Bank Act preemption of state usury laws applies only to a national bank, and not to a debt collector assignee of the national bank. The decision has potentially broad implications for all secondary markets in consumer credit in which loan assignments by national banks occur: securitizations, sales of defaulted debt and rent-a-BIN lending.

Unfortunately, the "Madden fix" bills are overly broad and unnecessary and will facilitate predatory lending. Specifically, the *Madden* fix bills claim to be restoring the so-called "valid-

when-made" doctrine, which, according to proponents of the legislation, means that the usurious or nonusurious nature of a loan is fixed at the time when the loan is made. The problem is that this particular doctrine is wholly concocted. There is a "valid-when-made" doctrine in commercial law, but it means something entirely different than the Madden fix proponents claim.



Bills to address concerns about the effects of the Madden court decision would facilitate predatory lending through schemes that have no purpose other than evading state usury laws.  
Adobe Stock

The actual "valid-when-made" doctrine provides that the maker of a note cannot invoke a usury defense based on an unconnected usurious transaction. The basic situation in all of the 19<sup>th</sup>-century cases establishing the doctrine involves *X* making a nonusurious note to *Y*, who then sells the note to *Z* for a discount. The discounted sale of the note can be seen as a separate and potentially usurious loan from *Y* to *Z*, rather than a sale. The valid-when-made doctrine provides that *X* cannot shelter in *Y*'s usury defense based on the discounting of the note. Even if the discounting is usurious, it does not affect the validity of *X*'s obligation on the note. In other words, the validity of the note is a free-standing obligation, not colored by

extraneous transactions.

"Valid-when-made" was a sensible and indeed critical rule for 19<sup>th</sup>-century commercial law. In the 19<sup>th</sup> century, negotiable instruments such as notes passed as currency, and their liquidity depended on them being "travelers without baggage," such that parties could accept them without undertaking diligence beyond the four corners of the note itself. The rule is not only practical, but also just — why should *X* get a windfall because of *Y*'s separate dealings with *Z*?

But notice that the actual valid-when-made doctrine has absolutely nothing to do with the Madden situation. The consumer in the court case did not attempt to invoke the rights of the national bank against the debt collector. Instead, the consumer's argument was that the interest rate on the debt was usurious — and clear — under state law from the get-go. The state usury law's application is preempted by the National Bank Act as applied to national banks, but only as to national banks; the National Bank Act does not void the state usury law, only stay its application. Once the note leaves the hands of a national bank, the state usury law applies as it always would. This too is a sensible outcome. National banks are not subject to certain state laws because they are subject to an alternative federal regulatory regime. An assignee of a national bank is not subject to that regulatory regime, however, so it should not get that regime's benefits lest there be a regulatory vacuum. And because consumer debts are not used as currency, there is no policy reason to enhance their liquidity by excusing debt purchasers from basic diligence.

The point is that Madden did not reverse long-standing case law; the National Bank Act was not held to preempt state usury laws in any circumstances until 1978. Instead, Madden reversed some relatively recent assumptions of the financial services industry about the scope of National Bank Act preemption in secondary markets, the foundations of which I questioned in a 2009 article. The Madden fix bills are not restoring long-standing doctrine, but creating it out of whole cloth to meet the financial services industry's desires about what the law should be, not what it is.

The flawed legal foundations of the Madden fix bills also present another problem: They fail to incorporate an important corollary doctrine. The courts have consistently distinguished between a situation in which there is a legitimate loan and an unconnected usurious

transaction, and situations in which the assignee is the true lender and the assignment is a sham. Thus, the sale of defaulted loans to a debt collector who has had no input in the loan's underwriting is entirely different under this doctrine than a rent-a-BIN operation, in which the assignee is substantially involved in marketing and underwriting the loans.

The Madden fix bills fail to distinguish between these situations. Instead of merely protecting relatively benign financial transactions, like credit card securitization or even facilitating a secondary market in defaulted loans, the Madden fix bills are actually facilitating predatory lending through rent-a-BIN and rent-a-tribe schemes that have no purpose other than the evasion of state usury laws and other consumer protections.

In any event, it's not clear that the Madden court decision poses any problem that needs fixing. The bills cite a single, unpublished academic study that shows that some marketplace lenders responded to Madden by limiting credit to borrowers with low FICO scores. The study does not indicate the total dollar amount of that credit contraction, much less if it was offset by increased lending from other sources, or its effect on consumer welfare. We simply don't know the net effect of Madden on credit markets.

Even if there were a net reduction in credit as a result of Madden, that access to credit must be balanced against sensible borrower protections. If access to credit were everything, we should be eliminating limitations on debt collection and allowing consumers to pledge their children and organs as collateral.

Usury laws are the oldest form of borrower protection known. They are blunt tools, but that is also their virtue, insofar as they are easy to administer. Congress should be hesitant to do a quickie, backdoor repeal of laws that have been on the books since colonial times, especially as state legislatures are free to repeal their usury laws directly.

It's reasonable to rethink the role of state usury laws in national credit markets, but any erosion of consumer protections on the state level must be matched by a strengthening of those protections on the federal level, such as with a federal usury floor or an ability-to-repay requirement. Sadly, the Madden fix bills don't do this, and instead gut state usury laws in the name of restoring an imaginary legal doctrine that never existed.



**Adam J. Levitin**

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January 30, 2018

*Testimony of*

**Brian Peters**

*On Behalf of*

**FINANCIAL INNOVATION NOW**

*before the*

**Financial Services Committee**

**Subcommittee on Financial Institutions and Consumer Credit**

**United States House of Representatives**

**“Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace”**



January 30, 2018

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**“Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace”**

Thank you Chairman Luetkemeyer, Ranking Member Clay, and members of the Committee for the opportunity to testify. My name is Brian Peters, and I am the Executive Director of Financial Innovation Now (FIN), an alliance of leading innovators promoting policies that empower technology to make financial services more accessible, safe and affordable for everyone.<sup>1</sup> FIN member companies include Amazon, Apple, Google, Intuit, and PayPal.<sup>2</sup>

These companies are at the forefront of America’s economic growth. They collectively employ over 700,000<sup>3</sup> people and spend more on R&D, over \$40 billion annually, than any other companies in the United States.<sup>4</sup> Their technologies enable the creation of whole new businesses and industries, and they empower individual consumers with tools to live more productive, healthier lives.

***Technology Transformation***

Technology and the mobile internet are changing the way consumers and small businesses manage money, access capital, and grow commerce. As innovators, FIN members are driving

<sup>1</sup> For more information regarding FIN’s policy priorities and principles, please visit <https://financialinnovationnow.org>

<sup>2</sup> Today’s testimony represents the views of FIN, not any one of its members individually.

<sup>3</sup> FIN data collected from publicly available sources.

<sup>4</sup> See Rani Molla *Tech companies spend more on R&D than any other companies in the U.S.*, RECODE (Sept. 1 2017) <https://www.recode.net/2017/9/1/16236506/tech-amazon-apple-gdp-spending-productivity>



January 30, 2018

new financial products and services that help small businesses create jobs across the country and empower individuals to reach their financial goals. From real-time peer-to-peer payments to new lending services, we strive to meet customer demand for digital tools that solve many kinds of financial challenges. In many cases we do this in cooperative partnership with traditional financial services providers who likewise recognize our mutual strengths.

The combined result has been an increase in access to financial services, lower costs to consumers and small businesses, and an increase in healthy competition among firms. Technological change is now a fundamental, inseparable part of modern financial services. And this change is accelerating.

***Financial Inclusion – Mobile Access to Money***

Mobile financial technologies, such as digital wallets and peer-to-peer payments, help improve financial health because they enable instant access to finances and real-time movement of money. These technologies enhance financial capability directly, and they also enable traditional financial entities to make depository accounts more manageable, and help users to avoid high-cost alternatives.

The Federal Deposit Insurance Corporation (FDIC) found that in 2015 nearly twenty five percent of American households remain unbanked or underbanked, but also found that “use of smartphones to engage in banking activities continues to grow at a rapid pace...” and “this growth presents promising opportunities to use the mobile platform to increase economic inclusion.”<sup>5</sup> The FDIC has also found that consumers agree that mobile banking services help “to address weaknesses in traditional banking,” particularly by helping consumers “reduce fees, better track their finances, and improve on-the-spot decision making.”<sup>6</sup>

For those consumers who still rely on cash, companies like PayPal and Amazon are enabling users to add cash to their accounts using an app, digitizing that money for online transactions.<sup>7,8</sup> PayPal recently partnered with Acorns to allow PayPal users to take better control over their financial lives by saving and investing.<sup>9</sup>

<sup>5</sup> Federal Deposit Insurance Corporation, 2015 FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS (2016), <https://www.fdic.gov/householdsurvey/2015/2015report.pdf>

<sup>6</sup> Federal Deposit Insurance Corporation: OPPORTUNITIES FOR MOBILE FINANCIAL SERVICES TO ENGAGE UNDERSERVED CONSUMERS (2016), [https://www.fdic.gov/consumers/community/mobile/MFS\\_Qualitative\\_Research\\_Report.pdf](https://www.fdic.gov/consumers/community/mobile/MFS_Qualitative_Research_Report.pdf) at 3.

<sup>7</sup> See David Huen, PayPal’s New Prepaid Card Upsells to the Underbanked, AMERICAN BANKER (Feb. 12, 2014), [http://www.americanbanker.com/issues/177\\_31/paypal-prepaid-unbanked-underbanked-1046670-1.html](http://www.americanbanker.com/issues/177_31/paypal-prepaid-unbanked-underbanked-1046670-1.html).

<sup>8</sup> See Sarah Perez, Amazon Cash, the service that lets you shop online, arrives at 7-Eleven, TECH CRUNCH (Nov. 6, 2017), <https://techcrunch.com/2017/11/06/amazon-cash-the-service-that-lets-you-use-cash-to-shop-online-arrives-at-7-eleven/>.

<sup>9</sup> See Joanna Lambert, You Can Now Use PayPal to Fund and Investment Account with Acorns, PAYPAL STORIES, (Nov 20, 2017) <https://www.paypal.com/stories/us/you-can-now-use-paypal-to-fund-an-investment-account-with-acorns?categoryId=company-news>



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While the mobile internet is improving *access* to money, the *speed* of money can also matter, particularly for the half of Americans who live paycheck to paycheck.<sup>10</sup> It does not make sense that, in our modern era of instant communications, it can still take up to five days for a payment to clear. This unnecessary delay causes many Americans to turn to high-cost alternatives. People should not have to choose to pay twenty dollars to access their money quickly rather than run the risk of late charges or overdraft fees.<sup>11</sup> Real-time payments clearing would help to alleviate these problems. Many other countries already have real time payment systems, including Mexico, the United Kingdom, India, and Singapore.<sup>12</sup>

In the United States, the Federal Reserve is shepherding a commendable industry-led effort to achieve faster payments ubiquity by 2020. FIN is participating in this effort and is very supportive of the Fed's work on this important goal.<sup>13</sup> It is FIN's hope that real-time payments can soon be widely available twenty-four hours a day, seven days a week.

#### ***Financial Inclusion - Small Business Empowerment and Access to Capital***

Financial innovation has also begun to solve similar access problems for small businesses. The costs of payment systems, reputation building, and loans have often excluded small businesses from full participation in the financing market. But now, new technologies are allowing small businesses (and micro-businesses) and workers to more easily take instant digital payments from customers online and on Main Street. Amazon, for example, supports millions of third party sellers, many of which are small businesses. Moreover, services such as "AmazonPay" and "Pay with PayPal" are tools that help small businesses earn credibility, expand their customer base, and accept card payments safely and securely online. Small businesses are also using innovations in payroll technology, inventory management, sales and data analytics, shipping logistics, and rewards programs, all of which make basic elements of running a business faster and less expensive.

The integration of the above technologies into a small business operation can facilitate fast and convenient access to capital. For example, Intuit's QuickBooks Capital platform enables small businesses to share financial information from their QuickBooks accounting software with financing partners so the small businesses can easily and quickly apply for the financing they need to grow their businesses. Intuit recently announced that it is offering its own lending product – utilizing this QuickBooks information. PayPal utilizes merchant card payment information, in partnership with a commercial bank, to facilitate working capital loans for small businesses. The use of these alternative data sources is valuable when assessing the

<sup>10</sup> Nearly half of Americans could not cover an emergency expense costing \$400. See Federal Reserve: REPORT ON THE ECONOMIC WELL-BEING OF U.S. HOUSEHOLDS IN 2015 (2016), <https://www.federalreserve.gov/2015-report-economic-well-being-us-households-201605.pdf>

<sup>11</sup> See Aaron Klein, *How the Fed can help families living paycheck to paycheck*. BROOKINGS CENTER ON REGULATION AND MARKETS, SERIES ON FINANCIAL MARKETS AND REGULATION, (November 22, 2017) <https://www.brookings.edu/research/how-the-fed-can-help-families-living-paycheck-to-paycheck/>

<sup>12</sup> See Deloitte, REAL-TIME PAYMENTS ARE CHANGING THE REALITY OF PAYMENTS.

<https://www2.deloitte.com/content/dam/Deloitte/us/Documents/strategy/us-cons-real-time-payments.pdf>

<sup>13</sup> See Press Release, *U.S. Faster Payments Governance Framework Formation Team announced*, FEDERAL RESERVE BOARD OF GOVERNORS (October 13, 2017) <https://www.federalreserve.gov/newsevents/pressreleases/other20171013a.htm>



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whole picture of the small business and has been a driving force in enabling access to credit for small businesses that may not have access through traditional sources.

Traditional small business lending processes are paper intensive, manual, and time consuming.<sup>14</sup> The technology integrations of FIN member companies, in contrast, enable small businesses to utilize their data in the application and underwriting process, enabling streamlined processing and typically more favorable outcomes for the small business (eg. lower rates, higher rate of approvals). Financing is made available to small businesses when it is most needed, and funds are made available immediately or within one business day. Intuit's QuickBooks Capital platform has helped over 10,000 small businesses gain access to over \$700 million in capital, and its own loan product, in a limited rollout over the past 6 months, has already funded over \$42 million for small businesses,<sup>15</sup> and, as of 2017, PayPal has loaned \$3 billion to 115,000 small businesses.<sup>16</sup>

This access to capital has benefited small businesses that typically are not able to obtain financing from traditional lenders. QuickBooks Capital is able to successfully fund small businesses that have less annual revenue, slightly lower FICO scores and are younger in business than that of traditional lenders. Similarly, an analysis of PayPal's working capital loan program found that between October 2014 and March 2015 a significant percentage of PayPal's loans went to businesses in counties that had lost banks since the financial crisis, and nearly 35% of these loans went to low-and-moderate-income businesses, versus 21% of loans from traditional retail banks.<sup>17</sup>

The Federal Reserve Bank of Philadelphia and the Federal Reserve Bank of Chicago recently released a study examining the data of one financial technology lender and found that lending activities have penetrated areas that could benefit from additional credit supply, such as those that lose bank branches... and that "the use of alternative information sources has allowed some borrowers who would be classified as subprime by traditional criteria to...get lower priced credit...."<sup>18</sup>

<sup>14</sup> See Karen Gordon Mills and Brayden McCarthy, *The State of Small Business Lending: Innovation and Technology and the Implications for Regulation, Working Paper 17-042*, HARVARD BUSINESS SCHOOL, (2016)

[http://www.hbs.edu/faculty/Publication%20Files/17-042\\_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf](http://www.hbs.edu/faculty/Publication%20Files/17-042_30393d52-3c61-41cb-a78a-ebbe3e040e55.pdf).

<sup>15</sup> See Rania Succar, *\$500 Million Reasons to Use the Quickbooks Financing Platform*,

<https://quickbooks.intuit.com/blog/news/500-million-reasons-use-quickbooks-financing-platform/>.

<sup>16</sup> See Usman Ahmed, Thorsten Beck, Christine McDaniel, and Simon Schropp, *Filling the Gap How Technology Enables Access to Finance for Small- and Medium-Sized Enterprises*, INNOVATIONS, Vol. 10/No.3/4, MIT Press, (2015), [http://www.mitpressjournals.org/doi/pdf/10.1162/inov\\_a\\_00239](http://www.mitpressjournals.org/doi/pdf/10.1162/inov_a_00239). ("Filling the Gap Paper")

<sup>17</sup> See *Filling the Gap Paper*, "Online business loans seem to have stepped in to fill the SME funding gap left in the wake of the 2008 financial crisis. A high proportion of PPWC loans are disbursed in zip codes that have experienced a relatively steep decline in the number of traditional retail banks, nearly 25 percent of PPWC loans were disbursed in the 3 percent of counties that have lost ten or more banks since the 2008 financial crisis."

<sup>18</sup> See Julapa Jagtiani and Catharine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information*, FEDERAL RESERVE BANK OF PHILADELPHIA AND FEDERAL RESERVE BANK OF CHICAGO, (July 6, 2017)

<https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2017/wp17-17.pdf>



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**Financial Management Tools**

Consumers are benefiting from a wide variety financial management software applications. For example, Intuit's Mint application, and its recently announced Turbo platform, gives consumers direct access to their financial information in one place, for free. These kinds of tools have helped millions of consumers and businesses create personal budgets, set savings goals, avoid unnecessary fees, find better offers and otherwise participate in the kind of simplified financial management that was previously available only to those who could afford a personal accountant.<sup>19</sup>

There are additional benefits. Open data can enable efficient and more reliable tools that provide verification of account ownership or loan application information. Broader permissioned data access permits more and varying data points to be used to verify identity, speed account onboarding, and reduce fraud. Account verification tools enable consumers to access other financial products and services, including peer-to-peer payment services, in real time rather than by delayed verification options, such as micro-transfers. Open data will be an important component of improving payment security – both in receipts and disbursements – as the U.S. moves closer to real-time payment and funds availability solutions on par with global adoption.

Consumers are accessing many of these digital tools in app marketplaces, such as Google Play and the Apple App Store,<sup>20</sup> and the vibrancy of these markets have dramatically lowered barriers to entry for thousands of entrepreneurs to innovate at scale and create new services and new jobs.<sup>21</sup>

The utility of these helpful tools depends on open data and a secure means whereby consumers can permission access to their financial accounts, ideally through secure open APIs (application programming interfaces).

The economic benefits of wide access to data to facilitate informed market choices are axiomatic. More information enables better choices. A McKinsey study estimates the potential value of wide access to data (or “open data”) to the U.S. economy across seven sectors, including consumer finance, to be approximately \$1.1 trillion.<sup>22</sup> This benefit ultimately accrues to consumers, but businesses also benefit as consumers make better-informed decisions and obtain lower costs for products and services. Today, the benefits of open data are manifesting themselves in many different aspects of consumers' lives, including with respect to consumer

<sup>19</sup> See Jason Zweig, *Inching Your Way Toward Wealth with Your Phone*, THE WALL STREET JOURNAL (Feb. 3, 2017), <https://blogs.wsj.com/moneybeat/2017/02/03/inching-your-way-toward-wealth-with-your-phone/>; See also, Geoffrey A. Fowler, *These Apps Can Finally Get You To Save Money*, THE WALL STREET JOURNAL (June 16, 2015), <https://www.wsj.com/articles/these-apps-can-finally-get-you-to-save-money-1434477296>

<sup>20</sup> See Mary Wisniewski, *Financial Apps Get Boost from Google*, FINANCIAL PLANNING (March 29, 2017), <https://www.financial-planning.com/news/financial-apps-get-a-boost-from-google>

<sup>21</sup> See The App Association, STATE OF THE APP ECONOMY 2 (4th Ed. 2016), [https://actonline.org/wp-content/uploads/2016\\_State\\_of\\_App\\_Economy.pdf](https://actonline.org/wp-content/uploads/2016_State_of_App_Economy.pdf).

<sup>22</sup> See McKinsey & Company, OPEN DATA: UNLOCKING INNOVATION AND PERFORMANCE WITH LIQUID INFORMATION 6 (2013), <http://www.mckinsey.com/business-functions/digital-mckinsey/our-insights/open-data-unlocking-innovation-and-performance-with-liquid-information>.

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transactions, travel, social networking, professional development, health care and education, allowing consumers to easily compare pricing for a wide variety of products and services.

### **Security**

FIN's members share the Committee's interest in maximizing data security and protecting the privacy of user information. In fact, the key areas where regulators worry about financial technology—the security and protection of digitized data—are the very areas in which technology companies have demonstrated the expertise and initiative to innovate most effectively.

As pioneers in the technology and e-commerce space, technology companies had to develop security capabilities in an era when few to none existed. Technology companies generally have no business *other* than their digital business, and maintaining user trust in their data security practices is critical. The technology industry therefore has strong incentives to employ exceptional data security practices.

The privacy and security practices of technology companies reflect not only strong incentives to protect data, but also the singular position the broader technology sector occupies when it comes to cybersecurity. Technology companies are in the business of developing cutting-edge technology, and as security threats have become more sophisticated and ubiquitous, technology companies have worked tirelessly to ensure they are sufficiently nimble and able to respond quickly to and neutralize new kinds of threats. Technology companies have also been the first to develop and adopt new security practices, like tokenization of payment data (the practice by which sensitive data like credit card numbers and many other types of data are replaced for back-office purposes with randomized numbers), end-to-end encryption of data, two-factor authentication (for example, requiring a one-time code sent by SMS in addition to a password), mobile device ID, and biometric authentication. Indeed, organizations that have serious security needs—like Northrup Grumman and the United States government—come *to* innovators like Google and Amazon for data and cloud security, and choose these kinds of companies because they are the best in the industry.<sup>23</sup> Notably, it is the marketplace that is driving better fraud prevention and consumer protection, often times exceeding what may be required by regulators.<sup>24</sup>

These security innovations are perhaps nowhere more tangible in financial services than FIN member companies' payment technologies. When many hear “mobile payments” they think of Apple Pay, PayPal, or Android Pay. That technology—which generally involves using a smartphone to make payments rather than cash or plastic cards—is not only convenient and

<sup>23</sup> In 2013 the Central Intelligence Agency selected Amazon Web Services to build and run a secure cloud to be used by 17 intelligence-related agencies. See *Intelligence community loves its new Amazon cloud*, FORTUNE (Jun. 29, 2015), <http://fortune.com/2015/06/29/intelligence-community-loves-its-new-amazon-cloud/>; see also [www.fidoalliance.org](http://www.fidoalliance.org) (describing the Fast IDentity Online Alliance, an open standard for stronger, simpler online authentication, pioneered by technology companies).

<sup>24</sup> For a detailed discussion of security requirements and oversight of financial technology providers, see Financial Innovation Now, WHITE PAPER: EXAMINING THE EXTENSIVE REGULATION OF FINANCIAL TECHNOLOGIES (July 2016), [https://financialinnovationnow.org/wp-content/uploads/2016/07/Examining\\_the\\_Extensive\\_Regulation\\_of\\_Financial\\_Technologies.pdf](https://financialinnovationnow.org/wp-content/uploads/2016/07/Examining_the_Extensive_Regulation_of_Financial_Technologies.pdf)



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faster, but third parties have consistently found that it is also more secure than plastic cards.<sup>25</sup> And a more consequential trend has begun - the diffusion of these secure payment methods throughout multiple communication and retail channels. “Invisible payments” will become far more pervasive in the future and significantly change the nature of commerce and money. These forms of payment are likely to be seamlessly woven into a wide variety of consumer and business interactions, including through browsers, secure messaging apps, easy-to-integrate buy-buttons, available via all manner of screens and screenless devices, such as wearables, voice assistants, and other IoT technology.

Contrary to the mistakenly held view that convenience and security have an inverse relationship, evolving payment technologies are *both* more secure and more convenient, speeding commerce and lowering fraud, and removing friction from the economy.

### Conclusion

Financial Innovation Now thanks the Committee for the opportunity to provide input on financial technology. We believe financial services are in a period of significant transformation and these changes give policymakers an excellent opportunity to try new approaches that enhance economic participation and improve access.

The benefits outlined above could be enhanced through a modernized financial regulatory structure that keeps pace with innovation and meets the needs of today’s consumers and commerce. The current structure is needlessly fragmented and inconsistent among federal regulators, and varies widely across state jurisdictions.<sup>26</sup> FIN submits the attached policy proposals for the Committee’s consideration.

Thank you for considering our views and we look forward to working with the Committee constructively towards a better financial services system.

<sup>25</sup> See, e.g., Joanna Stern, *Chip Card Nightmares? Help Is on the Way*, THE WALL STREET JOURNAL (Aug. 2, 2016), <https://www.wsj.com/articles/chip-card-nightmares-help-is-on-the-way-1470163865>

<sup>26</sup> See Brian R. Knight, *Federalism and Federalization on the Fintech Frontier*, VANDERBILT JOURNAL OF ENTERTAINMENT & TECHNOLOGY LAW, VOL. 20, ISSUE 1, 2017 (2017), <http://www.jetlaw.org/journal-archives/volume-20/volume-20-issue-1/federalism-and-federalization-on-the-fintech-frontier/>; See also, Financial Innovation Now, WHITE PAPER: EXAMINING THE EXTENSIVE REGULATION OF FINANCIAL TECHNOLOGIES (July 2016), [https://financialinnovationnow.org/wp-content/uploads/2016/07/Examining\\_the\\_Extensive\\_Regulation\\_of\\_Financial\\_Technologies.pdf](https://financialinnovationnow.org/wp-content/uploads/2016/07/Examining_the_Extensive_Regulation_of_Financial_Technologies.pdf);



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***FIN Policy Recommendations***

**National Money Transmission License:** Payment innovators currently must obtain and continually renew money transmission licenses in nearly every state. Each state has their own regulations, varying definitions for the same terms, and differing licensing, reporting and consumer protection requirements. Consumer protection is a critical part of payments regulation, but it does not make sense for different states to regulate digital transactions differently from one state to another, especially if that process significantly delays entry to market, creates differing regulatory expectations, and prevents consumers and businesses in many states from having equal and consistently safe access to cutting edge payments technologies.

*FIN Recommendation: Establish an optional federal money transmission license, managed by the Treasury Department, that: 1) oversees application and licensing, safety and soundness, BSA/AML compliance; 2) incorporates a number of existing state money transmitter laws and Uniform Money Services Act requirements; 3) preserves the current state structure for those wishing state licenses; and 4) offers uniform federal law only for an applicant choosing a federal license.*

**Assess Consumer Choice and Innovation in Card Payments and Security:** Technology innovators are developing numerous online payment options for consumers and merchants, along with a variety of methods to ensure security and authenticate payments conveniently. This constant evolution is necessary to drive down fraud and stay ahead of hackers. In contrast, incumbent financial services companies are building closed and proprietary networks, which lock out innovation, decrease consumer choice, and diminish the greatest potential security and fraud reduction methods.

*FIN Recommendation: Update reporting provisions of the Card Act to include regular assessment of 1) the impact of card network requirements on consumer choice and access to payment methods; 2) the process used to determine network requirements and standards, and its impact on market access and interoperability; 3) the alignment of network fees with actual security risk and fraud cost; 4) merchant barriers to consumer use of online and mobile payment options; and 5) the potential for risk-based network fees to incentivize better security, decrease fraud, and lower costs for consumers and businesses.*

**Ensure Consumer Access to Financial Accounts and Data:** Consumers are using new applications and technology to better manage their financial lives and leverage financial data to qualify for better rates and services. Consumers should have access to this data in whatever format they wish.

*FIN Recommendation: Preserve the ability of consumers to permission access to consumer financial account data securely and easily, using whatever secure application or technology they wish, without charges or restrictions that unreasonably favor any one application or technology over another.*



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**Streamline Access to Capital via the Internet:** America’s consumers should have easy access to safe forms of credit. Antiquated state lending rules did not contemplate internet-based services, and the complexity and inconsistency of the state laws (without the added benefit of uniform consumer protection) may actually hold back the availability of capital in places where it is most needed, especially for small businesses. Further exacerbating these problems, recent court decisions have created uncertainty regarding some lenders ability to operate across certain state lines, running contrary to internet-based lending and the National Bank Act.

*FIN Recommendations:*

1. Fix the “valid when made” doctrine. FIN supports the Protecting Consumers’ Access to Credit Act of 2017 and thanks the Committee for passing this necessary legislation.
2. Monitor and regularly assess agency efforts to facilitate entry of new lending business models that offer better access and affordability for consumers and small businesses, and explore alternative federal approaches if such entry does not occur.

**Help Consumers and Businesses Manage Money with Real-time Payments:** In the US, payments and check deposits can take days to clear through the legacy bank systems, whereas other countries already have real-time payments. American consumers cannot afford delays in accessing their own money. Unfortunately, these delays cause many Americans to instead turn to high-cost check cashing alternatives or pay-day loans to cover real expenses.

*FIN Recommendation: Require the Federal Reserve to ensure the availability of real-time payment networks for all Americans by 2020 and ensure such networks are affordable and secure.*

**Centralize Technology Leadership and Promotion:** As innovators, we believe strongly in a balanced regulatory environment that promotes market-based solutions. We are pleased that some federal financial regulators have recently recognized the tremendous benefit of new financial technologies, particularly its ability to grow commerce and help the underserved. These agencies have developed a number of initiatives and programs to enable innovation in financial services. For example, the Consumer Financial Protection Bureau, through Project Catalyst, encourages consumer-friendly innovation and actively engages with the innovator community. It has pioneered a nascent no-action letter program that may offer a valuable “testbed” for new technologies navigating regulatory obligations. Likewise, the Office of the Comptroller of the Currency’s “Innovation Initiative” is seeking to improve the agency’s understanding of technology trends and better facilitate responsible innovation for its chartered institutions and their partners. It is helpful that these agencies have embraced the benefit of technology-enabled competition in financial services and are exploring ways to foster this growing part of our economy. These efforts may benefit from greater coordination and technology leadership across the federal government for policy and government technology itself.

*FIN Recommendation:*



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1. *Establish a Treasury Undersecretary of Technology, responsible for coordinating efforts across all federal financial regulators to foster technological innovation in financial services, government use of modern technology, and greater regulatory efficiency and consistency.*
2. *Urge financial regulators to embrace technology and enable innovation in financial services, including flexible approaches to licensing and chartering that can facilitate new entrants and greater competition.*
3. *Require IRS to provide a digital portal for consumers and 3<sup>rd</sup> parties on their behalf to quickly and securely verify tax return data. FIN supports the IRS Data Verification Modernization Act of 2017.*
4. *FIN supports the goals of the Financial Services Innovation Act of 2016 and greater efforts by regulators to facilitate introduction and testing of new technologies and services.*

**Tech-Neutral Security:** As financial regulators develop guidance on privacy and security, we strongly encourage the Committee to urge adoption of technology-neutral approaches, and *not* standards that require one specific technological solution for security. In recent years, security technology has advanced rapidly, at times changing dramatically in scope in short periods of time. Some of these changes might have been predicted, such as advancements in encryption algorithms and practices. But others would not have been, such as the use of two-factor authentication to add a human check on password theft, the rise of web-based APIs (secure interfaces for software to retrieve data from another source), or the advancement of smart email filters that minimize “social” or “phishing” attacks on data. And many changes have come as institutions migrate from traditional fortresses of data behind firewalls to more agile cloud-based systems. In all cases, technology-specific rules would minimize the benefit of these innovations. Moreover, single-technology security solutions are in fact antithetical to what today’s security experts view as best practice, because they lock data into a single system of protection that attackers are then at leisure to learn how to exploit. Simply put, specific technology requirements will not keep pace with innovation.

*FIN Recommendation: Encourage financial regulators to ensure that future guidance or regulation is principles-based and technology neutral. Doing so will continue to allow innovation to thrive and parties to adapt in response to ever-changing security threats. Such an approach should apply to both financial institutions and technology providers, freeing both to focus on the latest security approaches.*



**Statement of Andrew M. Smith  
Partner, Covington & Burling LLP**

**Subcommittee on Financial Institutions and Consumer Credit  
Committee on Financial Services  
United States House of Representatives  
Hearing on “Examining Opportunities and Challenges in the Financial Technology  
(‘Fintech’) Marketplace”**

**January 30, 2018**

Chairman Luetkemeyer, Ranking Member Clay, and members of the Subcommittee, thank you for the opportunity to appear before you to testify about opportunities and challenges in the fintech marketplace.

My name is Andrew Smith, and I am a partner at the law firm of Covington & Burling LLP, where I co-chair the Financial Institutions Practice Group. I also serve as the Chair of the Consumer Financial Services Committee of the American Bar Association, and I am a Fellow of the American College of Consumer Financial Services Lawyers. Earlier in my career, I worked at the Federal Trade Commission (“FTC”) on financial services issues.

I am appearing today on my own behalf, but we represent many companies and trade associations in the fintech space and have many years of experience with these issues. You have asked me to discuss “the opportunities and challenges posed by fintech in the financial services marketplace, the current regulatory landscape, the need to amend the regulatory landscape or the necessity to amend existing financial laws or develop new legislative proposals that would allow financial services entities to use fintech to deliver new products and services to consumers.” In response to your request, I want to focus on three key points:

(1) *Bank partnerships with fintech providers are good for consumers.* The ultimate promise of fintech – delivering safer, more transparent, lower cost and more convenient financial

products and services to consumers over the Internet and mobile devices – depends on the ability of banks, particularly community banks, to cooperate with third-party fintech providers to offer financial products and services to consumers.

(2) *Bank partnerships are rigorously supervised.* Banks of all sizes routinely rely on third parties to provide critical services and also to purchase loans originated by the bank. A robust regime of third-party supervision has been established at the federal banking agencies to ensure that activities that occur outside of the bank are examined and supervised to the same extent as if they were being conducted by the bank itself, thereby protecting consumers and the financial system. Bank-sponsored lending programs with fintech firms are no exception, and the FDIC has published detailed guidance as to how these relationship should be managed and supervised.

(3) *New and inconsistent court decisions threaten to undermine bank partnerships with fintech providers.* A relatively recent litigation trend threatens the ability of community banks to expand access to credit through partnerships with third-party fintech providers. Some courts have taken it upon themselves to look beyond the actual, legal rights and responsibilities with respect to a particular loan transaction, and have instead examined the facts and circumstances of each individual loan transaction to consider who is the “true” lender – the bank or the fintech provider. That is, even though the bank is the legal lender to whom the borrower is obligated to repay the loan, the court is willing to ignore the loan agreement and instead examine the differing interests and motives of the various participants in the transaction. These decisions upend the reasonable commercial expectations of all of the participants in the loan transaction and threaten to discourage banks and fintech providers from entering into partnerships with one another. Legislation has been introduced which would ameliorate the situation by clarifying

what we knew all along: if a bank loans money to a borrower, and the borrower promises to repay the bank, the bank – not the bank’s vendor or service provider – is the lender.

**Bank Partnerships with Fintech Providers Are Good for Consumers (and for Banks)**

Banks routinely rely on relationships with vendors to deliver financial services more broadly, more efficiently, and with less risk to consumers, the economic system, and the banks themselves. While individual banks may not have all of the technical know-how to market, underwrite, originate, service and collect personal loans over the Internet, they have access to a wide variety of vendors who have the requisite technical expertise, as well as sources of funding which can share the risk of the loans with the bank. These vendors may have made significant investments in new technology and analytics, with many years spent developing and refining their expertise. To enter these new markets, banks could create their own systems from scratch at great expense and delay or partner with those who already have proven expertise. These partnerships allow the bank to deploy its own capital to make new loans, thereby providing broader access to credit for consumers.

Banks, particularly smaller or community banks, can extend their reach and diversify their risk profile by partnering with nonbanks to offer credit to consumers. Nonbank fintech providers can bring expertise to the table that the bank would not otherwise have – for example, expertise in electronic and Internet marketing of loans, innovative underwriting and credit risk assessment techniques, or online statementing and servicing of loans. Access to this new technology might enable a smaller bank to originate loans through new channels, such as the Internet; to new markets, such as small businesses; to borrowers outside of the bank’s traditional

footprint; or to borrowers of lesser credit quality, such as thin-file or no-file consumers. New technology also might allow a bank to more narrowly target its offers or more accurately customize its product offerings, thereby offering its products more efficiently. All of this means more competition among providers of credit, lower costs of credit, and more options and access to credit for consumers.

The Center for Financial Services Innovation, in a recent comment letter to the FDIC, characterized this as a “win-win-win” for all involved, including consumers. Banks win because they can serve a broader and deeper segment of the consumer market than they otherwise could. Third-party fintech providers win by creating an opportunity to offer products and services to consumers that they would not otherwise reach. Consumers win because they “get access to high-quality credit that they otherwise would not.” And, these partnerships can allow “smaller and more rural banks to broaden the set of products and services they can offer to consumers and small businesses in their communities.”<sup>1</sup>

The FDIC, in proposed examination guidance for third-party lending programs, echoes these sentiments: “Third-party lending arrangements may provide institutions with the ability to supplement, enhance, or expedite lending services for their customers. Engaging in third-party

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<sup>1</sup> CFSI Comment Letter on Proposed Guidance for Third-Party Lending (Oct. 27, 2016), <https://cfsinnovation.org/research/cfsi-comment-letter-on-proposed-guidance-for-third-party-lending/>.

lending arrangements may also enable institutions to lower costs of delivering credit products and to achieve strategic or profitability goals.”<sup>2</sup>

Indeed, smaller banks might need the ability to partner with fintech providers to offer credit to consumers just to survive. According to an American Bankers Association “Fintech Playbook,” by 2020, community banks could lose as much as \$15 billion in revenue to fintech firms and other banks going digital, if they failed to keep up.<sup>3</sup> But, if these community banks are able to adopt financial technologies, they could stand to *gain* as much as \$20 billion in revenue by 2020. The ABA projects roughly \$100 billion in revenues for the community bank segment in total, so the \$35 billion revenue swing resulting from failure to adopt financial technology is an enormous need.

#### **Bank Partnerships Are Rigorously Supervised**

Any loans issued by a bank – including those that benefit from the technology of a fintech partner – are subject to the same high-level of scrutiny and regulation that any other loan issued by the bank would be. This ensures borrowers are protected and supervision is appropriate, and enables consumers to choose to work with a federally-licensed lender, giving them greater confidence and security.

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<sup>2</sup> FDIC, Proposed Guidance: Examination Guidance for Third-Party Lending (July 29, 2016), <https://www.fdic.gov/news/news/financial/2016/fil16050a.pdf>.

<sup>3</sup> American Bankers Association (ABA), Fintech Playbook (Oct. 17, 2016), [https://www.aba.com/Press/Documents/2016\\_FintechPlaybook\\_ES.pdf](https://www.aba.com/Press/Documents/2016_FintechPlaybook_ES.pdf).

Although banks are not typically subject to state licensing, consumer protection, and rate-and-term requirements,<sup>4</sup> they are instead subject to a pervasive federal supervisory program, as well as the full battery of federal consumer protection regulations. The regulators have issued extensive guidance that impose substantial obligations on banks when they engage third parties. When a bank has not fully complied with the standards, the regulators have brought enforcement actions. Moreover, the regulators also may directly examine a third-party fintech firm with respect to its relationship with a bank.

In this context, recent FDIC supervisory guidance lays out an aggressive and robust regime for supervision of third-party lending arrangements with fintech providers, including 12-month examination cycles for institutions with significant third-party lending program relationships along with concurrent risk management and consumer protection examinations. In addition, the FDIC specifies that it will conduct targeted examinations of specific and significant third-party lending arrangements, including direct examination of a third party's corporate governance, financial strength, compliance management systems, credit underwriting administration, model risk management, vendor management, audit, information safeguarding, consumer complaints and litigation – not to mention transaction testing of individual loans to assess compliance with consumer protection regulations.

In this guidance, the FDIC repeatedly stated its expectation that an individual bank engaged in third-party lending activities is responsible for ensuring that its fintech partner is in compliance with all consumer protection and fair lending requirements “to the same extent as if

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<sup>4</sup> *See, e.g.*, 12 U.S.C. § 85; *Beneficial Nat. Bank v. Anderson*, 539 U.S. 1 (2003).

the activities were handled within the [bank] itself.” The agency made clear that the bank must establish the credit underwriting and administration standards; that all loans, not just those held in portfolio, must be included in performance monitoring and sensitivity analyses; and that banks conducting significant third-party lending activities would be expected to maintain capital well above any regulatory minimums.

In addition to outsourcing marketing, origination or servicing functions to third-party fintech firms, banks may also rely on third parties for liquidity. More specifically, banks that grant credit in connection with partnerships with fintech providers will frequently hold the loan for only short periods of time before selling the whole loan or a participation to the fintech partner or another third party. The sale of all or part of a loan, however, is routine in all lending markets – auto, student, mortgage, credit card, etc. – and is a critical means of freeing up bank capital, providing banks the liquidity necessary to get back to the business of lending. Greater liquidity enhances the safety and soundness of banks and leads to broader availability of credit, which in turn drives economic growth.

Moreover, the sale of a loan does not relieve a bank of the risks and obligations associated with any lending program. As lender and regardless of any later transactions, the bank must comply with several consumer protection laws, including Truth in Lending, fair lending, credit reporting, unfair and deceptive practices, and privacy. In addition, the bank must have in place rigorous risk management policies and procedures that keep pace with the growth of a lending program and that protect the bank should a third party responsible for purchasing the loan production be unable to perform as agreed. Further, a bank continues to bear credit risk for loans sold if the bank is subject to repurchase requirements or otherwise guarantees the purchaser

against any risk of loss. The FDIC guidance explains these risks and the appropriate bank response in greater detail.

So, permitting banks to partner with fintech companies to offer credit products to consumers does not let the bank, or the fintech provider, off the hook. The federal banking agencies aggressively police and supervise these programs, and the banks themselves remain at risk in these transactions, even where the loan is sold.

#### **Proposed Legislation Would Fix Uncertainty over Inconsistent “True Lender” Decisions**

Despite the demonstrated consumer benefits and consumer protections associated with banks’ third-party lending arrangements with fintech providers, a handful of courts have called these arrangements into question, holding that – even though the bank signed the loan agreement, the bank funded the loan, and the borrower promised to repay the bank – the bank may not be the “true lender,” rather, the service provider could be the “true lender.” These courts look past the explicit terms of the loan agreements, preferring instead to rely upon other facts and circumstances, such as who marketed the loan, who hosted the website, who designed the product, who developed the underwriting algorithm, who serviced the loan, who collected the loan, who bore the costs of the loan program, how long the bank held the loan, whether the bank sold the loan and on what terms, how profitable the program was for each party, and who has the subjectively determined “predominant economic interest” in the loan.

These cases are significant because, if the bank is the true lender, then it is subject to the federal bank regulatory framework. If the fintech firm is the true lender, however, then the fintech firm may be subject to different State licensing requirements and the loan itself may be

subject to State rate and term regulation, including limits on the interest rate that can be charged. In some states, this might even void the loan or make it uncollectible, meaning that the lender may not even be able to recover its principal, much less its costs and profit.<sup>5</sup>

In many of these “true lender” challenges, the loan in question was originated by a federally supervised bank, consistently with well-settled principles of federal law, and months or years after the fact, the justified expectations of the bank, the fintech firm, the loan purchasers and investors, and all of the other participants in the loan transaction are upset by a court that looks beyond the terms of the loan agreement and invalidates not only that single transaction, but potentially entire portfolios of loans. This after-the-fact overturning of parties’ expectations introduces significant uncertainty and unpredictability into the lending market, which in turn can diminish market liquidity. Liquidity requires clear, predictable, and uniform rules for banks to follow in the origination and sale of loans, and liquidity is critical to a stable and robust lending market.

A handful of these “true lender” challenges have been brought in the last several years. Some courts have relied upon the loan agreement to hold that the bank is the true lender,<sup>6</sup> and

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<sup>5</sup> We note that the “true lender” argument is different than the “valid when made” issue raised by the *Madden v. Midland* case. See *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015). In *Madden*, a loan originated by a bank was charged off and sold by the bank to a debt buyer. The debt buyer argued that because the loan was valid when it was made by the bank, any fees that could be charged by the bank also can be charged by the debt buyer. In a true lender challenge, however, it is the validity of the underlying loan that is under attack, the allegation being that the loan was originated by a nonbank in violation of State law. In other words, a defendant never gets to a “valid when made” challenge, unless it first survives the “true lender” challenge.

some have been willing to look beyond the loan agreement to entertain claims that the non-bank vendor has the “predominant economic interest” in the transaction and is the true lender.<sup>7</sup>

It is hard to determine what explains these varying outcomes, and that is of course the challenge for banks, fintech firms and investors. Without certainty, these market participants will no longer be willing to enter into these types of transactions, thereby depriving consumers, banks and the economy of the many benefits of bank partnerships with fintech providers while also hampering the liquidity necessary to support a robust lending market.

Legislation has been introduced that would reconfirm and reinforce existing federal law with respect to a bank’s identity as the true lender of a loan originated by a bank with the assistance of a third-party service provider. Specifically, H.R. 4439 would resolve any uncertainty about a bank’s ability to use third-party service providers by confirming the principle that when a bank enters into a loan agreement, it is the bank that has made the loan. A bank thus may export its location-state’s interest rate on any loan to which the bank is a party. The

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<sup>6</sup> See *Beechum v. Navient Solutions, Inc.*, 2016 WL 5340454 (C.D. Cal. Sept. 20, 2016); *Sawyer v. Bill Me Later, Inc.*, 23 F. Supp. 3d 1359 (D. Utah 2014); *Discover Bank v. Vaden*, 489 F.3d 594 (4th Cir. 2007) *rev’d and remanded (on other grounds)*, 556 U.S. 49 (2009); *Hudson v. ACE Cash Express, Inc.*, 2002 WL 1205060 (S.D. Ind. May 30, 2002); *Krispin v. May Dept. Stores Co.*, 218 F.3d 919 (8th Cir. 2000); *cf. SPGGC, LLC v. Ayotte*, 488 F.3d 525, 534 (1st Cir. 2007).

<sup>7</sup> See *Consumer Fin. Protection Bureau v. CashCall, Inc.*, 2016 WL 4820635 (C.D. Cal. Aug. 31, 2016); *CashCall, Inc. v. Morrissey*, No. 12-1274, 2014 WL 2404300 (W. Va. May 30, 2014) *cert. denied sub nom. CashCall, Inc. v. Morrissey*, 135 S. Ct. 2050 (2015); *Bankwest, Inc. v. Baker*, 324 F. Supp. 2d 1333 (N.D. Ga. 2004), *aff’d*, 411 F.3d 1289 (11th Cir. 2005), *en banc review granted*, 433 F.3d 1344 (11th Cir. 2005), *vacated for mootness*, 446 F.3d 1358 (11th Cir. 2008); *People ex rel. Spitzer v. County Bank of Rehoboth Beach*, 846 N.Y.S.2d 436 (2007); *cf. Commonwealth of Pa. v. Think Finance, Inc.*, 2016 WL 183289 (E.D. Pa. Jan. 14, 2016); *Ubaldi v. SLM Corp.*, 852 F. Supp. 2d 1190 (N.D. Cal. 2012).

proposed legislation also would effectively confirm that the full relationship between the bank and the online lender comes under the close scrutiny of the bank's federal regulator, including the extensive supervisory regime outlined above. We believe that by reinforcing existing federal banking laws, the proposed legislation would provide much-needed guidance to courts and help preserve the benefits of bank-fintech partnerships for consumers and the economy in general.

\* \* \*

Thank you again for the opportunity to testify before you today. I am happy to answer any questions.



January 29, 2018

The Honorable Blaine Luetkemeyer  
Chairman  
House Financial Services Committee  
Subcommittee on Financial Institutions  
and Consumer Credit  
2129 Rayburn House Office Building  
Washington, D.C. 20515

The Honorable William Lacy Clay  
Ranking Member  
House Financial Services Committee  
Subcommittee on Financial Institutions  
and Consumer Credit  
4340 O'Neill House Office Building  
Washington, D.C. 20515

Dear Chairman Luetkemeyer and Ranking Member Clay:

The Consumer Financial Data Rights (“CFDR”) Group appreciates the opportunity to share its perspective regarding the financial technology market and respectfully submits this letter for inclusion in the record for today’s subcommittee hearing entitled “Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace.” We commend you for convening this timely and important hearing.

The CFDR Group is a consortium of approximately 40 fintech firms that have united in support of the consumer’s right to use innovative, technology-based tools to improve their financial wellbeing. CFDR member firms vary in size, scale and use case but collectively provide valuable financial services products and services to more than 100 million American consumers and small businesses across the country. The firms in our ranks use technology platforms to provide vital access to capital, important personal financial management assistance, rewards and loyalty points monitoring, investment tools, and many other types of critical products and services that empower Americans to take better control of their finances.

The fuel that powers all of these innovations is data: the ability of consumers to affirmatively access their own financial transaction and account information without restriction, safely and securely, and in real time.

Americans need new and better tools to help them manage their finances. According to the Federal Reserve’s most recent survey of Americans’ economic well-being, approximately one-third of Americans are struggling financially and more than 40 percent of Americans were unable to pay their bills at least one month within the last year. Nearly half of American

households would have to incur debt or sell assets to pay for a surprise \$400 expense.<sup>1</sup> Another recent study found that fully 31 million Americans expect that they will die with unresolved credit card debt.<sup>2</sup> More Americans are dependent on financial data access to care for their loved ones: 45 percent of consumers over the age of 50 have authorized a partner or family member to access depository and investment accounts by sharing login credentials.<sup>3</sup> In addition, there are 45 million Americans who do not have credit scores, either because they are credit invisible or unscorable.<sup>4</sup> The only sustainable path toward improving Americans' financial lives is one that allows consumers and small businesses alike to leverage intuitive, powerful technology tools that rely on access to their financial information to help them improve their financial health.

Advances in technology have enabled innovative new tools that allow consumers to increasingly take control of their financial lives. Without the ability to safely and securely permission access to their financial information to third-party tools, no American consumer or small business would be able to take advantage of these innovative financial technologies that have come to market in recent years.

Fintech applications only use financial account information when and to the extent that consumers have affirmatively granted permission to do so. Yet, as the number of fintech use cases has increased, obstacles to the effective use of data have arisen. Over the last several years, some U.S. financial institutions have sought to institute a range of technical and administrative hurdles that would interfere with consumers' ability to use third-party tools. These financial institutions have moved to limit the amount of data that consumers can share, or are seeking to define bilateral agreements with onerous contractual terms that would restrict consumers' ability to take full advantage of marketplace solutions that would empower them to improve their financial state. As a result, there are an escalating number of cases where consumers are excluded from engaging with fintech services best suited to improve their financial well-being. Financial institutions will assert that these restrictions are driven by their commitment to protect the security of their customers. Though some of the restrictions may be motivated by security concerns, the fintech market and traditional financial institutions increasingly compete with another; commercial interests in some cases create a market disincentive with regard to full-scale cooperation. Further, several financial institutions have shared with CFDR members that any restrictions they impose are attributable to regulations and supervisory policies, despite the application of the Gramm-Leach-Bliley Act on the fintech ecosystem. The unintended consequence of any such regulatory or supervisory policy is reductions in innovation and market competition, which ultimately impacts the consumer and small business.

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<sup>1</sup> *Report on the Economic Well-Being of U.S. Households in 2016*(Rep.). (2017, May). Retrieved January 24, 2018, from Board of Governors of the Federal Reserve System website:

<https://www.federalreserve.gov/publications/files/2016-report-economic-well-being-us-households-201705.pdf>

<sup>2</sup> *Poll: 2 in 3 Adults with Debt Doubt They'll Ever Live Debt-Free*(Survey). (2018, January 10). Retrieved January 24, 2018, from CreditCards.com website: <https://www.creditcards.com/credit-card-news/debt-free-living-survey.php>

<sup>3</sup> *Financial Innovation Frontiers*(Rep.). (2017, April). Retrieved January 24, 2018, from AARP website: <https://www.aarp.org/content/dam/aarp/home-and-family/personal-technology/2017/04/Financial-Innovation-Frontiers-AARP.pdf>

<sup>4</sup> *Data Point: Credit Invisibles*(Rep.). (2015, May). Retrieved January 26, 2018, from Consumer Financial Protection Bureau website: [http://files.consumerfinance.gov/f/201505\\_cfpb\\_data-point-credit-invisibles.pdf](http://files.consumerfinance.gov/f/201505_cfpb_data-point-credit-invisibles.pdf)

Several large economies have already achieved or are well along the road towards achieving a more innovative and competitive ecosystem by ensuring consumers can control their own financial data. The United Kingdom's Open Banking regime became a reality on January 13, after almost three years of coordination among financial institution, fintech, and policymaking stakeholders. Through Open Banking, U.K. citizens are assured unfettered access to their financial data and the ability to use fintech tools to help them improve their finances. In Europe, the second payment services directive ("PSD2") now provides a similar open framework for payment account services throughout the European continent. The governments of Australia, Singapore, Canada, Hong Kong, and India – just to name a few – are at varying stages of implementing similar regimes, all modeled after Open Banking and PSD2.

Unfortunately, the U.S. market is woefully behind with regard to addressing the fundamental questions regarding whether – and how – consumers and small business can leverage their own financial data to their economic benefit. Some progress has been made of late; however, following a public comment period and a field hearing on data access issues, the Consumer Financial Protection Bureau published non-binding principles for consumer-authorized financial data sharing and aggregation in October. The Office of the Comptroller of the Currency and the Federal Reserve Board have embarked on their own examinations of the issue of consumer and small business data access. And, at the state level, the Conference of State Bank Supervisors has created a fintech advisory group that has connected state regulators with fintech firms in the spirit of finding collaborative answers to important questions raised by innovations in technology such as data access.

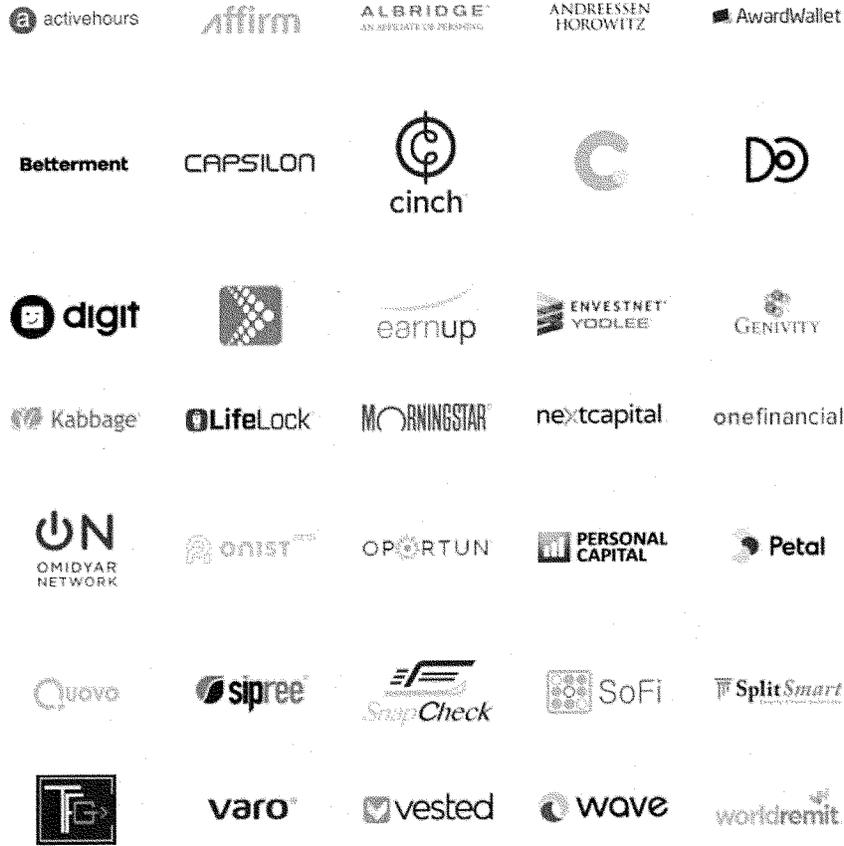
Of course, more work remains to be done in the private sector as well as the public sector. Collaboration among all market participants and coordinated engagement from the regulatory community will be critical to ensure that American consumers and small businesses can continue to take advantage of fintech tools that help them improve their financial wellbeing, and that the U.S. market remains an innovative leader in financial services amidst a technology-driven sea change.

The CFDR Group once again commends you for holding this timely and important hearing. If the CFDR can be of any assistance as the subcommittee continues to consider policy issues related to fintech, I hope that you will hesitate to contact me at (202) 876-2995, or at sboms@allonadvocacy.com.

Sincerely,



Steven Boms  
Consumer Financial Data Rights Group





January 29, 2017

Chairman Blaine Luetkemeyer and Ranking Member William Lacy Clay, Jr.  
U.S. House Financial Services Subcommittee on Financial Institutions and Consumer Credit  
2129 Rayburn House Office Building  
Washington, DC 20515

Dear Chairman Luetkemeyer and Ranking Member Clay:

On behalf of WebBank, thank you for holding this important hearing titled, “Examining Opportunities and Challenges in the Financial Technology Marketplace.” It is our firm belief that only a transparent, fair, and stable regulatory environment surrounding financial technology innovation will enable consumers, market participants, and financial companies to better participate in the economy and fully realize the gains of rapid technological progress. It will only be through effective Congressional leadership that such an environment will become a reality.

WebBank, a Federal Deposit Insurance Corporation (“FDIC”)-insured, Utah-chartered bank located in Salt Lake City, is a leader in the online lending industry, often referred to as “marketplace lending.” We use convenient and innovative online platforms to deliver financial products: fair and transparent loans for individuals and small businesses. Our core business involves partnering with non-bank financial companies, financial technology platforms, retailers, and manufacturers to offer revolving and closed-end credit to consumers and small businesses nationwide. Marketplace lending presents a novel method of consumer delivery, but the overall legal and regulatory architecture is well-established. Critically, despite the technological innovations inherent in our business model, WebBank remains subject to the full suite of bank regulations from the Truth In Lending Act to federal anti-money laundering provisions and maybe most importantly, examination and supervision from both the FDIC and the Utah Department of Financial Institutions.

Current federal law generally provides a good way for offering loans on a nationwide basis. However, the online lending industry is facing unnecessary and unwarranted challenges because some courts have reinterpreted longstanding rules and common understandings. Congress can promote the potential of financial technology by eliminating this uncertainty created by the courts. At present, this uncertainty represents the greatest threat to the viability of marketplace lending and business models similar to WebBank’s. A legislative fix of “true lender” and related *Madden v. Midland*<sup>1</sup> issues would remove the cloud that covers the online lending industry. In other words, the solution to both protect consumers and foster innovation already exists: allowing banks to partner with technology companies to offer products and services to customers. The fintech marketplace does not need a reinvention of the regulatory system, but rather a correction of uncertainty caused by incorrect court decisions.

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<sup>1</sup> *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015).



What follows is a discussion of the uncertainty engendered by true lender claims and the *Madden* decision, each an area where Congress, through simple, technical fixes, has the power to encourage innovation, spur economic growth, and promote broader financial inclusion.

#### I. Maintain Bank “True Lender” Status

Many marketplace lending platforms depend on partnerships with banks to originate loans. Relying on established federal law, these arrangements are structured in order to use a bank’s authority under the existing banking laws to “export” the interest rate permitted in the state where the bank is located. True lender cases seek to recharacterize a bank’s partner as the “true lender,” and thus to negate protection of the banking laws.<sup>2</sup> However, the claims in these cases fail to recognize the extensive compliance requirements and regulatory oversight that apply solely because a bank is involved in the lending process. When a bank is the lender, it necessarily brings the entire bank regulatory and examination system to bear on a given product, and the full range of consumer protections apply. Recently, federal and state courts evaluating true lender claims have adopted varying standards to determine whether the “true lender” is the bank or a non-bank partner, incorrectly injecting uncertainty into the market.

Some of these decisions look to factors that the courts believe will identify the entity with the “predominant economic interest” in a loan, but this approach is unpredictable in outcome and entirely unworkable for secondary market transactions on which U.S. financial markets depend. Simply put, any purchaser under this theory would need to be concerned about whether, by acquiring the loan soon after it was made, it might become (at least in the view of some courts) the “true lender.” Consider, for example, a 30-year mortgage that is originated by a bank and then sold after six months to a purchaser. Does the purchaser, who stands to collect the interest for the majority of the loan’s term, become the “true lender”? Would the answer change if a loan were instead sold three months or three weeks after origination? Such uncertainty directly undermines the efficient operation of a secondary loan market, which is an essential feature of a national credit system that makes credit widely available to consumers at the most favorable rates.

The threshold question for any true lender inquiry instead should be whether the loan is originated within the federal regulatory system. A loan originated within the federal regulatory system is subject to oversight and regulation by financial regulators, and it also is and should continue to be subject to long-established federal interest rate rules. Although this is the legal framework Congress created over two centuries of regulating national and state banks, courts today do not consistently apply the law as written. The inconsistent application of federal law is of particular and urgent concern in today’s ever-evolving online financial marketplace, where credit obligations are increasingly sold in the secondary market – with technological innovation enabling ever more efficient supplying of this credit precisely where it is needed, regardless of geographic and other concerns in prior eras. This vibrant secondary market also allows banks and other creditors to move risk off their balance sheets so they may make more loans.

<sup>2</sup> See, e.g., *CashCall v. Morrissey*, 2014 W. Va. LEXIS 587 (2014).



Additionally, many true lender cases are motivated by consumer protection concerns, illustrating a desire to protect consumers from products seen as abusive or predatory, chiefly the payday lending industry. While pursuing a noble end, courts in these cases employ misguided, overly broad means by focusing on the “predominant economic interest” in the loan.<sup>3</sup> This is an unworkable test because it ignores the secondary market for credit transactions. Whether through portfolio transfers, securitizations, or other common market mechanisms, lenders in today’s marketplace routinely transfer credit transactions – and the related risk and reward – to other entities. Moreover, when a loan is originated through the banking system it is already subject to oversight by the federal banking regulators, who have the authority to act on consumer protection concerns within the banking system. Banking regulators, indeed, have effectively eliminated bank participation in certain lending markets that were seen as abusive or predatory.

The consequences of true lender uncertainty are significant, creating foundational concerns about loan sales, limiting originations, and hindering economic growth. When a court ignores Congressional intent and the originating bank is deemed not to be the true lender, the third party risks losing the exportation advantage that the bank has, and could be subject to substantial penalties and fines for violating a state’s usury laws. This uncertainty and risk inhibits the offering and development of favorable products and services for a national market.

The disparate rationales and inconsistent application of true lender doctrine place a tremendous burden on online lending. While we are confident that the Supreme Court would eventually reject the attempts of states to enforce their varying concepts of true lender, such a decision may be years away and, of course, the eventual outcome of any such case cannot be known with certainty. Legislation is therefore the only way, in the near term, to clear the current cloud of true lender uncertainty that is hampering the effective and efficient provision of credit to consumers and small businesses. We support H.R. 4439, the bipartisan “Modernizing Credit Opportunities Act” introduced by Rep. Trey Hollingsworth. This legislation would effectively promote innovation through the existing bank-partner model by confirming that the status of a bank as the true lender – and its location under applicable law – does not depend on the location of that bank’s service provider or an economic relationship between the bank and another entity.

## II. Eliminate the Uncertainty of the *Madden v. Midland* Decision

The United States Court of Appeals for the Second Circuit upended the secondary market for consumer loans – including online lending but also the broader securitization and financing market – by reversing the longstanding “valid-when-made” doctrine that states a loan that is valid when made cannot become usurious by virtue of a subsequent transaction.<sup>4</sup> Specifically, the court in *Madden* held that the National Bank Act (“NBA”) did not preempt a state law usury

<sup>3</sup>See, e.g., *Salazar v. Ace Cash Express, Inc.*, 188 F. Supp. 2d 1282 (D. Colo. 2002).

<sup>4</sup>See, e.g., *Nicholas v. Fearson*, 32 U.S. 103, 109 (1833); *FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 148-49 (stating that the “non-usurious character of a note should not change when the note changes hands”).



claim brought against a non-national bank entity because the national bank was no longer involved with the loan that it had originated.

The Solicitor General and the Office of the Comptroller of the Currency (“OCC”) explained in a brief to the Supreme Court why the *Madden* case was wrongly decided and, indeed, conflicted with the NBA and prior Supreme Court decisions, but the Supreme Court denied certiorari.<sup>5</sup> This means that the Second Circuit’s decision, whose incorrect interpretation of federal law reversed fundamental understandings of the NBA and the common-law principles it implicitly incorporated when it was enacted in 1863, remains in effect. The court’s decision essentially held that the purchaser of a loan from a national bank was not entitled to federal preemption, which means that marketplace platforms and loan purchasers are vulnerable in the Second Circuit (New York, Connecticut, and Vermont). If other courts decide to follow the *Madden* precedent, the impact would be even greater. Already, plaintiffs’ lawyers and state regulators are seeking to expand *Madden*.

Similar to the true lender concerns discussed above, this misguided uncertainty makes it harder for depository institutions to make loans by leveraging the services of non-bank partner entities, which in turn impacts loan origination and curtails credit to borrowers in certain states, ultimately slowing economic growth. *Madden* limits access to credit, lender choice, and innovation in a promising growth sector of the financial marketplace.<sup>6</sup>

The Supreme Court is unlikely to resolve the conflict between the lower court decisions for some years. Congress can quickly fix the problem and address this uncertainty. We echo the view of both the OCC and the former Solicitor General<sup>7</sup> and support legislation to restore the pre-*Madden* status quo in line with Congressional intent and the valid-when-made rule. We enthusiastically support Rep. Patrick McHenry’s H.R. 3299, the “Protecting Consumers’ Access to Credit Act of 2017” that passed this committee with a broad bipartisan majority last

<sup>5</sup> See Brief for the United States as Amicus Curiae, p. 6, *Midland Funding, LLC v. Madden*, No. 15-610, *cert denied* (2016) (“The court of appeals’ decision is incorrect. Properly understood, a national bank’s . . . authority to charge interest up to the maximum permitted by its home State encompasses the power to convey to an assignee the right to enforce the interest-rate term of the agreement.”).

<sup>6</sup> See, e.g., *Public Input on Expanding Access to Credit Through Online Marketplace Lending*, Office of the Undersecretary for Domestic Finance, Department of the Treasury, 80 Fed. Reg. 42866 (July 20, 2015).

<sup>7</sup> See Brief for the United States as Amicus Curiae, p. 7-8, *Midland Funding, LLC v. Madden*, No. 15-610, *cert denied* (2016) (“Under the long established ‘valid-when-made’ rule, if the interest rate term in a bank’s original loan agreement was non-usurious, the loan does not become usurious upon assignment, and so the assignee may lawfully charge interest at the original rate . . . The power explicitly conferred on national banks by Section 85 [of the NBA]—i.e., the power to originate loans at the maximum interest rate allowed by the national bank’s home State—therefore carries with it the power to use the loans once originated for their usual commercial purposes, which include assignment of such loans to others.”).



November<sup>8</sup> and explicitly provides that the interest rate of a loan that is valid when made may be enforced by any third-party assignee to the same extent as the bank itself.

#### **Conclusion**

The current model whereby banks and non-bank entities partner to provide innovative credit solutions to consumers and small businesses is thriving. The result of these partnerships is greater financial inclusion through superior, constantly improving products efficiently delivered in ways consumers and small businesses desire. Simultaneously, federal and state regulator involvement mandates these innovations do not come at the expense of high levels of consumer protection. Additionally, the growth of marketplace lending allows smaller banks the opportunity to leverage technological innovation and partnerships with fintech firms to expand the credit available to consumers and create new sources of revenue, fostering overall economic growth along the way. Congress has the opportunity to ensure that this innovation continues and credit remains accessible to qualified borrowers at reasonable costs by eliminating the unwarranted uncertainty courts have imposed around these business models and partnerships. It is our hope that hearings such as this will help advance the dialogue to eventually remove this uncertainty and preserve the viability of online lending partnerships between banks and technology companies.

Again, thank you for this opportunity to share our views. We look forward to working with you.

Sincerely,

John McNamara  
Executive Chairman  
WebBank

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<sup>8</sup> Its identical Senate counterpart, S. 1642, was introduced by Senator Mark Warner in the Senate Committee on Banking, Housing, and Urban Affairs on July 27, 2017.



**Statement for the Record From John Taylor, President and CEO  
National Community Reinvestment Coalition**

**House Financial Services Committee,  
Subcommittee on Financial Institutions and Consumer Credit  
“Examining Opportunities and Challenges in the Financial Technology  
 (“Fintech”) Marketplace”**

**January 30, 2018**

Chairman Luetkemeyer, Ranking Member Clay, and Distinguished members of the Subcommittee:

The National Community Reinvestment Coalition (NCRC) appreciates the opportunity to provide this written statement for the record of the January 30, 2018 hearing on, “Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace.”

**CRA and Fair Lending Oversight of Fintechs:**

**Introduction**

Because financial technology companies (fintechs) have significantly increased their market presence over the last several years, it is imperative to apply rigorous Community Reinvestment Act (CRA) and fair lending standards on them. The lessons of the financial crisis are clear: when one part of the market is required to comply with comprehensive regulations and the other part of the market does not, the un-regulated part of the market will compete by offering abusive and risky loans. Extensive research by Federal Reserve economists and academics demonstrates that CRA-regulated banks offered safe and sound loans to underserved populations while non-CRA covered independent mortgage companies offered high cost and predatory loans with high default rates.<sup>1</sup> In order to avoid repeating the same mistakes of uneven regulation, federal

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<sup>1</sup> Elizabeth Laderman and Carolina Reid, Federal Reserve Bank of San Francisco, “CRA Lending during the Subprime Meltdown” in *Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act*, a Joint



agencies must apply comprehensive consumer protection regulations to fintechs now as they are increasing their market share.

A lack of data makes it difficult to know with precision the market share of fintechs. What is clear, however, is that fintech lending is increasing rapidly. Recent research documents that fintech consumer lending amounted to \$21 billion in 2016, an increase of 17 percent from the previous year.<sup>2</sup> According to a recent Federal Reserve survey, about 21 percent of small businesses with employees applied to fintechs for loans.<sup>3</sup> Although a significant number of small businesses applied to on-line lenders, it is unclear how many eventually received loans from fintechs. One research report estimates that 143,344 small businesses received loans from fintechs during 2016, which is only about two percent of small business loans (6,106,355) reported by banks that year.<sup>4</sup> This estimate of low market share, however, is not a reason for complacency among banks or regulators since it is apparent that fintech lending has been increasing significantly. Even a two percent market share can become 10 to 20 percent over the next decade.

While fintech lending has surged, evidence suggests that a significant amount of it is likely to be abusive. Consumer and small business borrower satisfaction with fintechs is currently low because of opaque and unclear disclosure of loan terms and conditions and high costs. Accion Chicago, a Community Development Financial Institution, reports that 20 percent of its customers are seeking relief from problematic loans, many of which were made by fintechs. Likewise, Opportunity Fund (based in California) found that a large sample of loans from fintech lenders featured high Annual Percentage Rates (APR) and unaffordable monthly payments.<sup>5</sup>

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Publication of the Federal Reserve Banks of Boston and San Francisco, February 2009, [http://www.frbsf.org/publications/community/cra/cra\\_lending\\_during\\_subprime\\_meltdown.pdf](http://www.frbsf.org/publications/community/cra/cra_lending_during_subprime_meltdown.pdf). Also, see Governor Elizabeth A. Duke, at the Revisiting the CRA Policy Discussion, Washington, D.C., February 24, 2009 *CRA: A Framework for the Future*, <http://www.federalreserve.gov/newsevents/speech/duke20090224a.htm>

<sup>2</sup> Tania Ziegler, E.J. Reedy, Annie Le, Bryan, Zhang, Randall S. Kroszner, Kieran Garvy, 2017: *The America's Alternative Finance Industry Report – Hitting Stride*, University of Cambridge and the University of Chicago, p. 15, [https://www.jbs.cam.ac.uk/fileadmin/user\\_upload/research/centres/alternative-finance/downloads/2017-05-americas-alternative-finance-industry-report.pdf](https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2017-05-americas-alternative-finance-industry-report.pdf), p. 15.

<sup>3</sup> Consumer Financial Protection Bureau, *Key Dimensions of the Small Business Lending Landscape*, May 2017, p. 26, [https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/201705\\_cfpb\\_Key-Dimensions-Small-Business-Lending-Landscape.pdf](https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/201705_cfpb_Key-Dimensions-Small-Business-Lending-Landscape.pdf)

<sup>4</sup> Ziegler, et al., p. 15 for number of loans going to fintechs. For total bank loans see, Federal Financial Institutions Examination Council, CRA National Aggregate Table 1 available via <https://www.ffiec.gov/CraAdWeb/pdf/2016/N1.PDF>

<sup>5</sup> Eric Weaver, Gwendy Donaker Brown, Caitlin McShane, “Unaffordable and Unsustainable: the New Business Lending on Main Street,” Opportunity Fund, May 2016



Pricing differences between bank and on-line lenders are also common.<sup>6</sup> Thirty-three percent of respondents to a Federal Reserve survey reported that they were not satisfied with interest rates of on-line lenders compared to just three percent and six percent reporting dissatisfaction with small bank and large bank interest rates, respectively.<sup>7</sup> Presumably, the higher rates of dissatisfaction associated with interest rates on the loans of on-line lenders corresponds to higher interest rates than those on bank loans.

As well as guarding against high cost or abusive products, the regulation of fintechs presents an opportunity to address the digital divide. The Federal Communications Commission's (FCC's) 2016 Broadband Progress Report concluded that 10% of Americans across the country still lack access to adequate broadband Internet service.<sup>8</sup> While only 4% of people living in urban areas lack adequate broadband services, this issue is particularly concentrated in rural areas and tribal lands, with 39% and 41% respectively, still lacking access.<sup>9</sup> It is important for fintechs to acknowledge this "digital divide" and work toward closing the divide through their charter applications. The Federal Reserve Bank of Dallas extols using CRA as an effective means of closing the digital divide and providing low- and moderate-income individuals access to safe and sound banking products.<sup>10</sup> Recently, the Federal Reserve Bank of Philadelphia released a working paper on fintech lending and found that fintechs can play a major role in filling a lending gap when bank branches close. In examining one online lender, the paper found that more than 75 percent of its newly originated loans in 2014 and 2015 were in areas where local bank branch locations were declining.<sup>11</sup>

If executed thoughtfully, fintech entrance into banking could help narrow the digital divide by providing underserved populations and communities with increased virtual access to banking. However, if charter applications and CRA examinations of fintechs do not meaningfully assess whether fintechs are in fact narrowing the digital divide the result could be the exact opposite.

<sup>6</sup> Eric Weaver, Gwendy Donaker Brown, Caitlin McShane, *Unaffordable and Unsustainable: the New Business Lending on Main Street*, Opportunity Fund, May 2016 documents the high cost of on-line fintech lending.

<sup>7</sup> Federal Reserve Banks, *Small Business Credit Survey*, April 2017, 17.

<sup>8</sup> <https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf>

<sup>9</sup> Federal Communications Commission, *2016 Broadband Progress Report*, Jan. 29, 2016, retrieved at <https://www.fcc.gov/reports-research/reports/broadband-progress-reports/2016-broadband-progress-report>.

<sup>10</sup> Ibid.

<sup>11</sup> Federal Reserve Bank of Dallas, *Closing the Digital: A Framework for Meeting CRA Obligations*, July 2016, retrieved at <https://www.dallasfed.org/assets/documents/cd/pubs/digitaldivide.pdf>

<sup>12</sup> Julapa Jagtiani and Catherine Lemieux, *Fintech Lending: Financial Inclusion, Risk Pricing, and Alternative Information*, Fed. Res. Bank of Philadelphia, Working Paper No. 17-17, July 6, 2017, 22, retrieved at <https://www.philadelphiafed.org/-/media/research-and-data/publications/working-papers/2017/wp17-17.pdf>



The digital and banking divide would then be exacerbated and a great opportunity to narrow it would be missed.

#### **Application of CRA**

CRA requires that banks serve credit needs of low- and moderate-income communities consistent with safety and soundness.<sup>12</sup> Since CRA is an affirmative obligation to lend responsibly, applying CRA or CRA-like requirements to fintechs will help curb abusive lending while also motivating fintechs to make more loans, investments, and services in low- and moderate-income communities. Three aspects of CRA need to be considered for fintechs: the role of CRA in the chartering process, ongoing CRA exams, and assessment areas. Each will be now considered in turn.

#### *Chartering Fintechs – FDIC*

During the summer and fall of 2017, two fintechs, Social Finance (SoFi) and Square, applied to the FDIC for an industrial loan charter (ILC). An industrial loan charter allows a depository institution to be owned by a non-bank. ILCs also typically have narrow product lines. NCRC opposes ILCs on safety and soundness grounds since federal regulatory agencies lack the authority to supervise ILC parents, which can include non-bank companies. During the financial crisis, two ILCs, Security Savings Bank, based in Nevada, and Advanta Bank Corp, based in Utah failed. In addition, a number of parents of ILCs, including Lehman Brothers, General Motors, Flying J Inc., Capmark Financial Group Inc., CIT Group Inc., and Residential Capital, LLC filed for bankruptcy.<sup>13</sup>

If SoFi and Square had applied for regular depository charters, NCRC would not oppose the applications on safety and soundness grounds but would insist on rigorous CRA plans. The fintech applications to-date do not display full adherence to the FDIC’s chartering requirements of serving community needs. The FDIC’s Statement of Policy indicates that criteria for approval of charter applications includes serving convenience and needs. The Statement describes convenience and needs factor as the following:

The essential considerations in evaluating this factor are the deposit and credit needs of the community to be served, the nature and extent of the opportunity available to the

<sup>12</sup> CRA statute, <https://www.law.cornell.edu/uscode/text/12/2901>

<sup>13</sup> Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on De Novo Banks and Industrial Loan Companies before the Committee on Oversight and Government Reform; U.S. House of Representatives; 2157 Rayburn House Office Building, <https://www.fdic.gov/news/news/speeches/spjul1316.html>



applicant in that location, and the willingness and ability of the applicant to serve those financial needs.

SoFi did not indicate a willingness to employ its ability or business niche to serving the needs of communities. The CRA plan that SoFi described in its application was offering a secured credit card, purchasing affordable housing bonds from the Utah Housing Corporation (UHC), making vague promises of financial education and counseling, and providing a scholarship program offering few scholarships. SoFi's business niche is to refinance student loan debt and SoFi markets itself to millennials. However, the CRA plan did not include marshalling this expertise to refinancing the student debt of lower income students, many of whom are burdened by high debt levels.

Instead the main retail product SoFi's CRA plan envisioned offering lower income consumers was a secured credit card that is a higher interest rate product inferior to regular credit cards. The SoFi application states that "it is *felt* that revolving credit cards are not an appropriate credit instrument for a lower income community focus."<sup>14</sup> The notion expressed in the SoFi application that lower income customers can only handle secured credit cards rests on untested stereotypes of these customers as credit risks. This was emblematic of SoFi's entire application which did not involve careful research documenting credit needs of low- and moderate-income consumers and how best to meet those credit needs. Moreover, SoFi's geographical focus in its CRA plan was the Salt Lake City-Provo-Orem, Utah metropolitan area even though SoFi was a national lender (more on assessment areas below).

Square's application was an improvement over SoFi's. Importantly, Square indicated a desire to serve lower income, minority, and women businesses because small businesses are the main customers of Square. Square is a payment processor and has also started making small business loans based on data it obtains on processing payments. In its draft CRA strategic plan, Square outlines a numerical goal for community development finance expressed as a percent of assets. It also indicates that it will offer financial education on a national basis, provided it has met the needs of its assessment area.

While an improvement over SoFi's application, Square did not establish goals for serving low- and moderate-income borrowers and communities for its two main products – small business lending and payment processing. Square took an initial step with small business lending, saying it would establish performance measures including the percent of small business loans in low- and moderate-income census tracts. Goal setting, however, would go further than this. After

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<sup>14</sup> SoFi Application, 13.



calculating the performance measures, a lender would compare itself against its peers and establish goals such as meeting or exceeding peer performance in the percentage of loans in low- and moderate-income communities. Lastly, Square also restricts its assessment area to the Salt Lake City, Utah metropolitan area.

*OCC – Charter Applications and Proposed Charter for Fintechs*

The OCC, like the FDIC, received a fintech application for a bank charter during the summer of 2017. Varo, an on-line company that focuses on deposit products and financial management services for consumers, applied for a bank charter to the OCC in the summer. Varo’s application exhibited shortcomings similar to those described above.

In addition to Varo’s application, the OCC undertook a significant endeavor spearheaded by former Comptroller of the Currency Thomas Curry to establish a national charter for non-bank fintechs. This proposal was multifaceted, complex, and controversial. For starters, it would allow non-banks with a national charter to preempt state law. NCRC has steadfastly opposed proposals to expand preemption powers to additional lending institutions. At a minimum, NCRC stated in comments about the OCC’s fintech charter proposal that fintechs should be required to demonstrate how they would either comply with state consumer protection law or adhere to the basic protections (such as clear disclosures to consumers) embodied in the state laws.

The OCC did not establish a CRA requirement for fintechs since fintech charters would not be charters for depository institutions. The OCC, however, did indicate that fintechs applying for an OCC charter would be required to develop financial inclusion plans stating how the fintech would serve underserved communities. The financial inclusion plans would represent an advance over CRA in one sense in that plans for serving minorities could be included. The OCC draft licensing manual for fintechs did not explicitly say “minority” but referenced underserved communities which presumably could include minority communities.<sup>15</sup> CRA, in contrast, only describes obligations to low- and moderate borrowers and communities.

The financial inclusion plans would require fintechs to describe goals, establish performance measures, and milestones. The OCC states that community group input can help fintechs identify community credit needs. The fintech is to identify the geographical markets it will operate in, including underserved populations and geographical areas.<sup>16</sup>

<sup>15</sup> Comptroller’s Licensing Manual, Draft Supplement: Evaluating Charter Applications from Financial Technology Companies, March 2017, p. 20, <https://www.occ.gov/publications/publications-by-type/licensing-manuals/file-publication-fintech-licensing-manual-supplement.pdf>

<sup>16</sup> Ibid.



NCRC agreed with the OCC's interpretation that the National Banking Act (NBA) provides the OCC with authority to implement CRA-like obligations for non-depository fintech companies. The NBA describes the procedure for chartering new banks and financial institutions, including the criteria to which the proposed charter must adhere.

The implementing regulations of the NBA, 12 CFR § 5.20, describe a number of community reinvestment and fair access considerations and requirements. In a subsection called "requirements," the OCC states that it will assess if a need exists for the proposed institution in the community to be served and "whether there is a reasonable probability" of the institution's "usefulness." Whether a company is useful could be judged in part on the extent to which it will serve community credit needs. Another subsection (f) of § 5.20 called "policy" makes the reference to serving the community rather explicit. It states that a chartering consideration is whether the proposed institution will provide "fair access to financial services by helping to meet the credit needs of its entire community," and whether the institution would promote "fair treatment of customers."<sup>17</sup>

#### *Precedents for CRA and Financial Inclusion Plans*

Additional models for financial inclusion plans are the OCC's conditional merger approvals requiring CRA plans in the cases of Valley National Bank and Sterling Bank. These conditional merger approvals required marketing and outreach efforts which insured that low- and moderate-income consumers and communities were served in a fair and non-discriminatory manner. The CRA plans must also include annual goals and timetables and annual reporting to the OCC. The banks were required to also seek public input when developing their CRA plans.

More recently, NCRC has established community benefit agreements with several lending institutions including KeyBank and Santander establishing lending and investment goals to reinvest tens of billions of dollars in underserved communities. These community benefit agreements were often negotiated while a merger application was pending or by a bank desiring to improve its CRA performance. The performance measures committed to in these plans are similar to the ones discussed above and will result in improved performance and increases in lending and investing in future years.<sup>18</sup> The community benefit agreements also involved meetings around the country with hundreds of community organizations to discuss how the banks could best respond to community needs. Many of the features of the agreements reflect commitments to address needs such as needs for low balance mortgage loans in areas of the

<sup>17</sup> See 12 CFR § 5.20 available via <https://www.law.cornell.edu/cfr/text/12/5.20>

<sup>18</sup> For summaries of the community benefit agreements, see <https://ncrc.org/cra/>



country with depressed home values. The agreements also feature a monitoring mechanism consisting of advisory councils composed of community groups that review bank progress under the agreements and provide recommendations about how to improve performance.

*Recommendations for Chartering Fintechs*

As stated above, NCRC opposes the ILC charter and encourages fintechs and federal regulatory agencies to use charter authority that does not preempt state law and requires fintechs to adhere to comprehensive standards for serving communities in a safe and sound manner.

The concept of CRA strategic plans or financial inclusion plans as part of fintech applications is valuable and must be improved. Since fintech business models vary widely, a plan submitted as part of a charter application can allow for flexibility to accommodate the differences in the business models. For example, a plan for a payment processor will be different than a plan for a consumer lender. However, while allowing for flexibility, the plans must be rigorous with strong performance measures and geographical coverage (more on that below). The performance measures must not simply list numbers of loans or other products but include comparisons with industry peers so the public knows whether the fintech is proposing to be at or better than the level of its peers. The plans must also respond thoughtfully to community needs as identified through data analysis and discussions with community organizations.

A recent change in the Interagency Questions and Answers Regarding CRA (Interagency Q&A) can help inform the development of performance measures.<sup>19</sup> The Interagency Q&A advises that CRA examiners will scrutinize whether a financial institution's alternative delivery systems are effectively delivering services to low- and moderate-income populations by considering a variety of factors including: ease of access; cost to consumers; range of services delivered; ease of use; rate of adoption and use; and reliability of the system.<sup>20</sup> Fintechs should establish specific performance measures and goals for the low- and moderate-income community for each of these factors.

The FDIC's language about ability and willingness of the applicant to serve community needs should guide the development of CRA and financial inclusion plans. NCRC has suggested a guideline in our comments on fintech charter applications of whether the fintech applications display a willingness to use their abilities to serve needs. In particular, the fintech should use its

<sup>19</sup> Community Reinvestment Act; Interagency Questions and Answers Regarding Community Reinvestment Act Guidance, OCC, Board of Governors of the Federal Reserve System, FDIC, Fed. Reg. 81, 142 at 48506, <https://www.gpo.gov/fdsys/pkg/FR-2016-07-25/pdf/2016-16693.pdf>

<sup>20</sup> Interagency Q&A at 48542.



talent or expertise to develop products and programs that serve the needs of underserved populations. For example, a consumer lender refinancing student debt should not receive approval for a CRA plan that only offers secured credit cards to low- and moderate-income borrowers, and does not include this population in its plans to refinance student debt.

#### *Ongoing Examinations*

Describing a CRA or financial inclusion plan in a charter application is necessary but not sufficient for ensuring continued robust performance in meeting the needs of underserved communities in the future. To better ensure consistent and improving performance, federal examiners must periodically conduct evaluations and then provide written assessments of performance.

In the case of fintechs applying for depository charters, the federal agencies would conduct CRA evaluations. The fintechs would most likely opt to be evaluated under the strategic plan option. A strategic plan's time period cannot exceed five years, and a bank generally develops measurable goals for lending, investing, and services. Public input is required.<sup>21</sup> In the case of fintech charter applications, the public input occurs at the time of application. After the agency approves the plan, the fintech would operate under the strategic plan. Its next CRA exam would evaluate whether the fintech met the goals of the plan. CRA exam schedules are announced for the next two quarters (six months in advance) so community groups and other stakeholders have opportunities to comment on bank performance and possibly influence ratings. After the CRA exam, a fintech can then develop a new strategic plan and the CRA exam cycle repeats. Alternatively, the fintech could elect to be evaluated under one of the other CRA exam types that varies based on asset level.

In the case of the proposed OCC fintech charter, the frequency and type of evaluations of fintechs was still a work in progress. The OCC recognized that fintechs must serve underserved populations through the life of the charter and that the financial inclusion plans should be updated. However, how often and how the updates would be evaluated was left unclear. The OCC states:

The commitment to meet its financial inclusion goals, approach, activities, and milestones that support fair access to financial services and fair treatment of customers is ongoing through the life of the charter. For this reason, the OCC will require that the SPNB (fintech) update its financial inclusion plan (FIP) in appropriate circumstances.

<sup>21</sup> See the OCC version of the CRA regulation, Section §25.27, Strategic plan via [https://www.ecfr.gov/cgi-bin/text-idx?SID=d4ebf029aa7ade35dfb94a2ac306401b&mc=true&node=pt12.1.25&rgn=div5#se12.1.25\\_141](https://www.ecfr.gov/cgi-bin/text-idx?SID=d4ebf029aa7ade35dfb94a2ac306401b&mc=true&node=pt12.1.25&rgn=div5#se12.1.25_141)



The FIP should address how the SPNB will continue serving the needs of the relevant market and community beyond the initial years after a charter is granted.<sup>22</sup>

NCRC had urged the OCC to establish a periodic evaluation schedule similar to CRA exam schedules or other compliance exams that the fintech would undergo. As much as possible, the process should resemble CRA exams.

#### *Assessment Areas*

The fintech CRA strategic plans in charter applications to-date establish a fintech headquarter's location as its single assessment area to be evaluated on its CRA exam. This is per current CRA regulatory procedures establishing assessment areas to include areas where an institution's branches or deposit taking ATMs are located. Yet, the current CRA regulation procedure for fintechs results in a narrow assessment area that is not truly responding to credit and deposit needs where many fintechs conduct business. Narrow assessment areas will thus fall short of meeting the convenience and needs requirement for a charter application. The fintech applications to-date discuss how the fintechs serve the entire country. Accordingly, NCRC believes that the CRA plans ought to be national in reach.

It is a contradiction in terms for a branchless fintech to establish its assessment area where its headquarters is. In this case, the fintech is acting as if its headquarters location is a branch and as such, the headquarters location will make loans in its contiguous community. But the headquarters is not a branch and will not be used for making loans. This sleight of hand mocks the intention of CRA to serve credit needs wherever a lender is conducting business. To only establish one geographical area for a fintech's only or primary CRA responsibilities is a ruse that will enable fintechs to avoid rigorous CRA responsibilities in all communities in which they conduct a substantial amount of lending. The regulatory agencies must not enable this behavior through blinkered application of CRA and banking regulation.

The CRA regulations do not prohibit a branchless bank from establishing assessment areas beyond its headquarters. Assessment areas can include areas where substantial amounts of lending activity occur.<sup>23</sup>

<sup>22</sup> Comptroller's Licensing Manual, Draft Supplement, p. 22.

<sup>23</sup> See § 345.41 (c) (2), Assessment area delineation, of the FDIC CRA regulation via <https://www.fdic.gov/regulations/laws/rules/2000-6500.html#fdic2000part345.41>



Using loan data, NCRC believes that the agencies can require non-traditional banks and fintechs to create assessment areas that capture the vast majority of their loans. An example of lending by state for Lending Club during the time period of 2012 and 2013 shows that assessment areas can be meaningfully created for an on-line lender (a two year time period is a typical time period covered by a CRA exam).<sup>24</sup> Lending Club makes data on its lending activity by state and for three digit zip codes publicly available, a practice NCRC recommends for other fintechs.

Several states have sizable numbers of Lending Club loans in this time period even before Lending Club's substantial lending increases of more recent years. During 2012 and 2013, Lending Club made more than 188,000 loans; most of these were consumer-related loans and/or refinancing and consolidation of outstanding debt (see table below). Another table below on lending by state reveals that heavily populated states including California, New York, Texas and Florida had the highest percentage of loans. Ten states each had more than 3 percent of Lending Club's loans.<sup>25</sup> On the other end of the scale, 28 states each had less than 1.5 percent of Lending Club's loans. In sum, it is quite feasible for at least the top ten or twenty states to constitute assessment areas; these states had high numbers of loans and reasonably high percentages of Lending Club's loans. The top 15 states contain more than two thirds of Lending Club's loans.

To further investigate how assessment areas would work for a non-traditional bank, NCRC tabulated loans by three digit zip code and metropolitan areas for Texas, one of Lending Club's high volume states. We found five metropolitan areas with more than 1,000 loans each and one area, North Texas that could possibly be considered a rural area. The five metropolitan areas range in size and location across the state and include Houston, Austin, Ft. Worth, Dallas, and San Antonio. El Paso is the seventh largest area by loan volume with more than 500 loans. Using Lending Club as an example, designating metropolitan areas and counties as assessment areas for non-traditional lenders is feasible and can include a diversity of areas.

NCRC believes that assessment areas for fintechs must include rural areas. Populations in rural areas are less likely to be connected to the internet. If fintechs do not make efforts to serve rural areas, the digital divide disadvantaging rural communities will only widen.

Assessment areas must cover the great majority of fintech lending. NCRC's research has documented that when the assessment areas of large banks cover less than 50 percent of their

<sup>24</sup> See <https://www.lendingclub.com/info/statistics.action> for summary data tables and to download data.

<sup>25</sup> These states are CA, NY, TX, FL, IL, NJ, PA, OH, GA, VA.



lending, the ratings of the large banks on their lending tests are higher.<sup>26</sup> Higher ratings solely due to less coverage of lending on exams will ultimately cause lenders to relax their efforts to serve low- and moderate-income borrowers and communities. It is intuitive that less coverage of lending can lead to easier exams and inflated ratings. Lenders can focus their efforts to serve low- and moderate-income borrowers and communities in only those relatively few geographical areas and lending activities that are covered on CRA exams. It is easier to pass a CRA exam when less than 50 percent of an institution's loans are examined than when the great majority of an institution's loans are scrutinized.

#### Lending Club Loans 2012-2013

state	#loans	Percent
CA	30,743	16.3%
NY	16,257	8.6%
TX	14,558	7.7%
FL	12,848	6.8%
IL	7,313	3.9%
NJ	7,212	3.8%
PA	6,346	3.4%
OH	5,898	3.1%
GA	5,874	3.1%
VA	5,772	3.1%
NC	5,414	2.9%
MI	4,549	2.4%
WA	4,512	2.4%
MA	4,403	2.3%
MD	4,287	2.3%
AZ	4,272	2.3%
CO	3,953	2.1%
MN	3,230	1.7%
MO	2,956	1.6%
CT	2,906	1.5%
NV	2,769	1.5%
OR	2,570	1.4%

<sup>26</sup> NCRC, The Community Reinvestment Act and Geography, April 2017, available via [https://ncrc.org/wp-content/uploads/2017/05/cra\\_geography\\_paper\\_050517.pdf](https://ncrc.org/wp-content/uploads/2017/05/cra_geography_paper_050517.pdf)



AL	2,339	1.2%
IN	2,302	1.2%
WI	2,295	1.2%
LA	2,268	1.2%
SC	2,124	1.1%
TN	2,046	1.1%
KS	1,790	1.0%
KY	1,700	0.9%
OK	1,683	0.9%
UT	1,482	0.8%
AR	1,421	0.8%
HI	1,110	0.6%
NM	1,018	0.5%
WV	914	0.5%
NH	889	0.5%
RI	800	0.4%
MT	570	0.3%
AK	567	0.3%
DC	566	0.3%
DE	475	0.3%
WY	458	0.2%
SD	407	0.2%
VT	306	0.2%
MS	3	0.0%
NE	3	0.0%
ID	2	0.0%
IA	1	0.0%

Total 188,181

Purpose	# Loans	Percent
Car	1,951	1.0%
Credit Card		22.9%



	43,107	
Debt Consolidation	111,451	59.2%
Home Improvement	10,297	5.5%
Medical	1,519	0.8%
Small Business	2,745	1.5%
Miscellaneous	17,111	9.1%
<b>Total</b>	<b>188,181</b>	

Texas Zip Codes	# Loans	Percent
770, 72, 73, 74, 75 Houston	3,634	25.0%
750 North Texas	2,074	14.3%
760, 61, 62, 64 Ft. Worth, TX	1,836	12.6%
786, 87, 89 Austin, TX	1,360	9.3%
751, 52, 53 Dallas	1,215	8.3%
780, 81, 82, 88 San Antonio TX	1,084	7.4%
798, 99 El Paso, TX	527	3.6%
765, 66, 67 Waco, TX	455	3.1%
785 McAllen TX	361	2.5%
756, 57 East Texas	245	1.7%
793, 94 Lubbock, TX	231	1.6%
790, 91 Amarillo, TX	225	1.5%
769, 97 Midland, TX	208	1.4%
754 Greenville TX	198	1.4%
783, 84 Corpus Christi	195	1.3%
768, 78 Bryan, TX	155	1.1%
776, 77 Beaumont, TX	121	0.8%
795, 96 Abilene, TX	99	0.7%
759 Lufkin, TX	93	0.6%
763 Wichita Falls TX	77	0.5%
755 Texarkana	53	0.4%



779 Victoria, TX	50	0.3%
758 Palestine, TX	42	0.3%
792 Childress, TX	14	0.1%
Total	14,552	100.0%

Three digit zip codes, some metro areas had more than one zip code, some zip codes are abbreviated  
see <https://pe.usps.com/archive/HTML/DMMArchive20070717/print/L002.htm>

#### **Fair Lending Protections Must be Rigorous**

Fintechs pose significant fair lending concerns. They use unorthodox data evaluation and underwriting methods. Some employ algorithms that appear to apply criteria in a neutral fashion but could result in disparate impacts disproportionately disadvantaging protected classes. Carol Evans, a fair lending expert of the Federal Reserve System, advises fintechs to carefully consider fair lending implications of their data and underwriting methods. She suggests factors such as which post-secondary school applicants attended are not really connected with creditworthiness and that fintechs may want to think twice before using these factors in their underwriting criteria. She states that “generally the more speculative the nexus with creditworthiness, the higher the fair lending risk.”<sup>27</sup>

Another fair lending risk posed by fintechs is dual track lending in which a fintech purposefully or inadvertently uses zip codes or demographic characteristics to offer high cost products to underserved populations and more desirable products to white or male borrowers. Price disparities and discrimination of the type discussed above is also a pressing concern.

Given the complexity and wide variety of fair lending risks, fintech charter applications must include robust descriptions of fintech business models and how fintechs will comply with fair lending law and regulation. Subsequent exams including CRA and fair lending reviews must include rigorous evaluations of fair lending compliance.

There are fair lending frontiers that fintechs can help further develop. For example, federal law does not provide robust protections regarding disclosures of loans terms and conditions in small business lending. Fintechs can demonstrate voluntary but verified protections in this area. However, in their charter applications, some fintechs that make small business loans have not

<sup>27</sup> Carol A. Evans, “Keeping Fintech Fair: Thinking about Fair Lending and UDAP Risks,” in *Consumer Compliance Outlook – A Federal Reserve System Publication Focusing on Consumer Compliance Topics*, Second Issue, 2017, pp. 4-5, <https://www.frbsf.org/banking/files/Fintech-Lending-Fair-Lending-and-UDAP-Risks.pdf>



indicated whether they will adhere to the Small Business Borrower's Bill of Rights, a check-list of compliance including transparent disclosures of loan terms and conditions that have been endorsed by many lenders.<sup>28</sup>

Data disclosure laws must apply to fintechs so the general public and federal regulatory agencies can systematically verify that they are adhering to CRA and fair lending law and regulation. Data disclosure will enable federal agencies and members of the public to determine how the fair lending records of fintechs compare against traditional lending institutions such as banks and credit unions. If racial disparities in lending are more pronounced for fintechs than traditional lenders, further scrutiny of their underwriting, marketing approaches, and products would be warranted. Likewise, if fintechs are not as successful in lending to low- and moderate-income borrowers and communities, any CRA obligations for fintechs must be strengthened.

The Home Mortgage Disclosure Act (HMDA) regulations must cover fintechs, particularly if they make loans at levels similar to banks covered by HMDA. Likewise, when the Consumer Financial Protection Bureau (CFPB) develops regulations to enact Section 1071 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the CFPB must ensure that its regulation covers fintech small business lending. Finally, a number of fintech lenders are consumer lenders. When those fintechs apply to become CRA-covered banks, the federal regulatory agencies must require that their future CRA exams consider consumer lending and provide data on their consumer lending.

### **Conclusion**

Fintechs are still relatively new entrants to the lending marketplace, but they are increasing their lending and market share at a rapid pace. On the one hand, fintechs have the potential to narrow the digital and banking divide by increasing access to credit for populations underserved by banks. On the other hand, fintechs can end up exacerbating the banking and digital divide if oversight of fintechs is lax and the agencies do not expect strenuous fintech efforts to serve underserved populations.

When fintechs apply for either bank charters or any new OCC fintech charter, the agencies must expect rigorous CRA and financial inclusion plans with measureable goals of performance. Periodic CRA exams and fair lending reviews must be rigorous in order to provide incentives for fintechs to meet and/or exceed their performance goals. Assessment areas must be created that cover the great majority of fintech lending in order to ensure that fintechs are making

<sup>28</sup> <http://www.responsiblebusinesslending.org/>



considerable efforts to serve low- and moderate-income borrowers and communities. Lastly, given the novelty of fintech underwriting and marketing, fair lending reviews must be comprehensive and ensure that fintechs are not blatantly or inadvertently discriminating in their lending.

Please contact Josh Silver, Senior Advisor, at [jsilver@ncrc.org](mailto:jsilver@ncrc.org) with any questions about this paper.

**Statement of Representative Bill Posey (R-FL)**  
**To the House Financial Services – Financial Institutions and Consumer Credit Subcommittee**  
**Concerning the Hearing:**  
**“Examining Opportunities and Challenges in the Financial Technology (“Fintech”) Marketplace”**  
**January 30, 2018**  
**10:00 a.m.**

Mr. Chairman, Ranking Member, and Members of the Subcommittee,

Thank you for holding this hearing today. Our nation has succeeded so well because we have built a society where innovation is encouraged and rewarded. We get things done and we rate our tools and institutions in terms of how well we are able to achieve economic growth and prosperity. That is especially true of financial institutions and the products they bring to the market. There are some who fear innovation or even benefit from thwarting it. Some people believed that innovation ran ahead of itself during the lead up to the financial crisis.

But on balance, most observers – and certainly I agree – believe that over the long haul, financial innovation has been good for our country. For example, we’ve come a long way from the balloon mortgages of the depression that ruined so many homeowners to today’s fixed term, fixed rate mortgages. We have advanced homeownership through innovation. Today, we explore the intersection of two powerfully innovative sectors: finance and technology. Again, innovation promises a better life for everyone, including the little guys. I’m interested in how technological innovation changes financial institutions fundamentally or might usher in new regulatory needs.

**Question Series 1:** I’d like to address my first set of questions to **Mr. Nathaniel Hoopes, Executive Director of the Marketplace Lending Association**. Absent congressional action, what can federal regulators do to provide greater clarity to marketplace lending – for both borrowers and investors? Is rural America a focus for marketplace lenders? How is marketplace lending helping small businesses? Is there evidence that uncertainty around “valid-when-made” is affecting access to and cost of credit for borrowers?

**Hoopes Answer Series 1:** Marketplace loans can help borrowers in rural areas without easy access to bank branches -- as long as they have access to an internet connection. Researchers at the Philadelphia Federal Reserve bank found that loans from Lending Club are reaching borrowers in geographic locations where bank branches have recently closed, and importantly, that the cost on those loans is the same or lower than for comparative products available from traditional institutions. The upsurge in lending from online small business lenders is also filling a critical financing gap for small businesses across industries, according to a new study from NDP Analytics, a Washington, D.C.-based economic research firm. Their 2018 report on small business lending in the United States reveals that some of the nation's largest "FinTech" small business lending platforms funded nearly \$10 billion in online loans from 2015 to 2017, generating \$37.7 billion in gross output, creating 358,911 jobs and \$12.6 billion in wages in U.S. communities.

Unfortunately, the uncertainty around valid-when-made has clearly harmed consumers and small businesses – academic researchers have found there has been a measurable reduction in credit access for residents in the 2<sup>nd</sup> Circuit with lower credit scores. It makes sense -- if banks can't be confident that they can sell loans, they're going to extend less credit. Former Columbia University Professor Robert Jackson, who's now a Democratic member of the SEC, studied the issue and found that borrowers with credit scores under 625 saw a 52 percent reduction in credit access after the Madden decision.

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Furthermore, a new study from co-authors Piotr Danisewicz of the University of Bristol, and Ilaf Elard of the School of Finance at Shanghai University has found that the *Madden* decision has harmed citizens in a precarious financial position. They have analyzed how the availability of marketplace loans affects the incidence of personal bankruptcy in the United States. By using the 2<sup>nd</sup> Circuit U.S. Court of Appeals verdict as an exogenous source of variation in marketplace lending, they show that marketplace lending restrictions have precipitated a persistent rise in personal bankruptcy, particularly among low-income households. The paper relies on publicly available data. The full paper is now available here:

[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3208908](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3208908)

Finally, a recent Davis Polk white paper argues that the federal banking regulators should take action to protect the existence of a national consumer and small business lending market and clarify uniform standards for consumer protection. The MLA believes that balancing the important goals of consumer protection, availability of credit through a national lending market, and safe and sound bank lending—especially at a time of rapid technological change and innovation—is best achieved by a review of these federal banking regulators, who can establish standards across banks rather than through piecemeal efforts by courts deciding on individual cases that often present extreme facts. A national lending market, where consumers and businesses are able to access credit from many potential bank lenders through online services, will flourish best under uniform nationwide lending and consumer protection standards rather than a state-by-state patchwork of requirements.

<https://www.davispolk.com/publications/federal-banking-regulators-can-and-should-resolve-madden-and-true-lender-developments>

**Question Series 2:** This set of questions is for **Brian Peters, Executive Director of *Financial Innovation Now***. How do your products help underserved consumers and small businesses achieve their financial goals? Can you explain your current regulatory environment – are you regulated at the state or federal level or both? How are your companies improving access to capital for small businesses, and what kind of data do you use to determine creditworthiness?

**Question 3:** This question is for the **entire panel**. What is the number one challenge of the rapidly growing fintech sector that cannot be addressed by the existing constellation of federal and state regulations or related laws?

**Hoopes answer to Question 3:** Every fintech business model has unique challenges. The number one public policy challenge for the sector is that overlapping constellation of federal and state regulations and related laws referenced in the question. Chartered banking entities engaged in lending clearly benefit from both federal preemption and the low funding costs derived from federally insured deposits, fintech firms operating online must navigate the marketplace with neither. That is why efforts to bring burdensome regulation to the fintech industry are misguided, and as Brian Knight at the Mercatus Center has emphasized, regulators should seek to level the playing field at least with regards to a national operating framework to ensure that competition can flourish for the benefit of consumers and small businesses.

**Question 4:** This question is for the **entire panel**. Does the growth of the fintech sector really present new and pressing regulatory challenges, or are the regulatory solutions and needs being presented really issues that are being raised from other problems that are already on our radar screen?

**Hoopes answer to Question 4:** The unprecedented *Madden* decision does create a new and pressing regulatory challenge that did not exist as recently as 2015. The U.S. and global financial markets have been able to count on the contractual doctrine of *valid when made* for roughly 150 years, and suddenly the national market is being split by a misguided court decision. The decision has impacted loan origination, loan sales, securitizations, and ratings.

**Question 5:** This question is for the **entire panel**. We're aware that our national financial system sometimes shines a light on differences in the way states regulate activity and difference between states and the federal government. In the insurance sector, many experts point to the National Association of Insurance Commissioners as having provided an excellent service of coordinating insurance regulation. Federal regulation of insurance is very sparse. Should we try to encourage better coordination among the states as a way to cut back on some of the federal intervention in financial markets?

**Hoopes answer to Question 5:** Congress can encourage state regulators to do more to coordinate and harmonize their laws in consumer and small business lending, as well as state securities regulation, to account for the new internet era and digital marketplace lending. Consumers clearly stand to benefit when they are able to apply for a full range of products online rather than wait in line at a physical branch that might be 50 miles from their home or place of business and wait weeks for a lending decision. It's important to note that the Conference of State Banking Supervisors (CSBS) has offered some very constructive ideas to promote more harmonization of state law as part of their Vision 2020 initiative. Unfortunately,

some of the challenges associated with state regulation, such as inconsistent and overly complex state usury standards (often riddled with loopholes for opaque or even abusive financial products), as well as lack of clarity around licensing for fintech firms that provide services to supervised state or national banks are unlikely to be addressed by states in the near term, and therefore will benefit from a significant degree of federal input and oversight.



Congressman Bill Posey  
2150 Rayburn HOB  
Washington, DC 20515

Dear Representative Posey,

Thank you for the opportunity to testify before the subcommittee on January 30, 2018, at the hearing “Examining Opportunities and Challenges in the Financial Technology (‘Fintech’) Marketplace.” I am happy to provide answers to the posthearing questions (numbers 3, 4, and 5) you posed to me in your letter of February 21, 2018.

**Question 3: What is the number one challenge of the rapidly growing fintech sector that cannot be addressed by the existing constellation of federal and state regulations or related laws?**

Ironically, the number one challenge facing the fintech sector likely *is* the existing constellation of federal and state regulations or related laws. Specifically, the cost, complexity, and limitations posed by state-by-state regulation of nonbank lenders and money transmitters, combined with overarching federal regulation, risks placing nonbank fintech firms at a significant competitive disadvantage to their bank brethren, even if they offer equivalent products or services.<sup>1</sup>

To address this risk, the inconsistency and cumulative burden of regulation should be reduced to the greatest extent possible. There are several options to address this. These options include the pure federalization of financial services regulation, preempting the states entirely; the use of federally granted passporting of certain elements of a firm’s home-state law and licensing, similar to what state-chartered FDIC-insured banks currently enjoy under federal law; or states harmonizing their laws so that they are consistent.<sup>2</sup>

**Question 4: Does the growth of the fintech sector really present new and pressing regulatory challenges, or are the regulatory solutions and needs being presented really issues that are being raised from other problems that are already on our radar screen?**

The growth of fintech presents some challenges that, while not completely novel, are particularly acute within fintech at present. For example, questions about whether fintech lenders should be allowed to lend across state lines on the basis of their home-state law reflect the debate around banks in the 1970s and early 80s that resulted in section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA) granting state-chartered FDIC-insured

<sup>1</sup> For more on the problems of inefficiency, competitive inequity, and potential political inequity created by some state-by-state regulations, please see Brian Knight, “Federalism and Federalization on the Fintech Frontier,” *Vanderbilt Journal of Entertainment & Technology Law* 20, no. 2 (2017): 129–206.

<sup>2</sup> Brian Knight, “Modernizing Financial Technology Regulations to Facilitate a National Market” (Mercatus on Policy, Mercatus Center at George Mason University, July 2017).



banks regulatory parity with their nationally chartered peers.<sup>3</sup> The purpose of this provision was, as Senator Dale Bumpers, a proponent of DIDA said, to “allow[] competitive equity among financial institutions, and reaffirm[] the principle that institutions offering similar products should be subject to similar rules.”<sup>4</sup> The parallels between this historical example and the situation facing nonbank fintech lenders—and, to a degree, money transmitters—are clear.<sup>5</sup>

Likewise, while cryptocurrency (broadly defined) may present significant regulatory issues, many of these issues are driven by the particular uses (e.g., money transmission, investment) a cryptocurrency is being put to. Therefore, the regulatory issues present in money transmission, corporate securities, commodities, the sale of property, et cetera, will be present in the cryptocurrency space as well.

While the underlying issues may not be entirely novel, the combination of issues presented by fintech may be. To take cryptocurrency as an example again, while the regulation of commodities, securities, money transmission, and the sale of property are all existing issues, cryptocurrency may combine them or blur the lines between them in ways that are, if not completely unique, at least uncommon relative to more traditional methods of providing those same services. Thus, the unique regulatory challenge may not be a new type of transaction, but clarifying the barriers between existing bodies of regulation.

**Question 5: We’re aware that our national financial system sometimes shines a light on differences in the way states regulate activity and differences between states and the federal government. In the insurance sector, many experts point to the National Association of Insurance Commissioners as having provided an excellent service of coordinating insurance regulation. Federal regulation of insurance is very sparse. Should we try to encourage better coordination among the states as a way to cut back on some of the federal intervention in financial markets?**

Congress should encourage better coordination but be realistic in its expectations of what that will accomplish. For example, Congress has asked the states to coordinate their regulation of money transmitters since at least 1994,<sup>6</sup> but so far the regulation remains highly fractured.<sup>7</sup> Given the political and practical challenges with state coordination, and the risk that even if state

<sup>3</sup> Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 521, 94 Stat. 132, 164–65 (1980) (codified as amended at 12 U.S.C. § 1831d (2012)).

<sup>4</sup> *Greenwood Tr. Co. v. Massachusetts*, 971 F.2d 818, 826 (1st Cir. 1992) (quoting 126 CONG. REC. 6907 (1980) (statement of Sen. Bumpers)).

<sup>5</sup> The issue of the fractured state of money transmission regulation has long been on Congress’s radar, including its express desire to have the states harmonize their regulations with each other, a desire that goes back at least as far as 1994.

<sup>6</sup> See Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, § 407(b)(1)–(5), 108 Stat. 2160, 2248 (1994) (codified as amended at 31 U.S.C. § 5311 (2012)).

<sup>7</sup> See generally Thomas Brown, “50-State Survey: Money Transmitter Licensing Requirements” (Great Neck, NY: National Money Transmitters Association) (cataloguing the licensing and investigation requirements for money transmitters within each state); see also Kevin V. Tu, “Regulating the New Cashless World,” *Alabama Law Review* 65, no. 77 (2013): 91, 110.



coordination were achieved it would break apart over time,<sup>8</sup> it is questionable whether state coordination alone will become or remain an adequate solution.

However, this does not mean that Congress must entirely federalize fintech regulation. Instead, it should consider areas where it can allow the states to remain the primary substantive regulators but enable state-chartered or licensed entities to serve a national market via federal regulation. As discussed earlier, the use of federal law to allow state-chartered, federally insured banks to compete with their nationally chartered brethren, while leaving the substantive chartering and lending requirements to the states, provides a useful example. Congress could enable competitive federalism by allowing state-chartered or licensed entities to export their license or powers on par with the relevant powers of national banks.<sup>9</sup>

I hope this additional information is helpful in the committee's consideration of the regulation of fintech. Please feel free to contact me if I can provide any additional information.

Sincerely,

Brian R. Knight  
Director, Program on Financial Regulation and Senior Research Fellow  
Mercatus Center at George Mason University

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<sup>8</sup> Such drift has been seen in other contexts, including the Uniform Commercial Code (UCC). See generally John C. Minahan Jr., "The Eroding Uniformity of the Uniform Commercial Code," *Kentucky Law Journal* 79, no. 4 (1976): 799–822 (discussing how factors including amendments, subsequent state laws, and judicial decisions had reduced the degree of similarity between all states that nominally enacted the UCC).

<sup>9</sup> For more on potential options see Knight, "Modernizing Financial Technology Regulations"; see also J. W. Verret, "A Dual Non-Banking System? Or a Non-Dual Non-Banking System? Considering the OCC's Proposal for a Non-Bank Special Purpose National Charter for Fintech Companies, against an Alternative Competitive Federalism System, for an Era of Fintech Banking" (George Mason University Law & Economics Research Paper No. 17-05, Arlington, VA, 2017), 35–37.

**Responses of Professor Adam J. Levitin to  
Questions for the Record from Representative Bill Posey (R-FL)  
House Financial Services Committee  
Financial Institutions and Consumer Credit Subcommittee  
“Examining Opportunities and Challenges in the Financial Technology  
 (“Fintech”) Marketplace”  
January 30, 2018  
10:00 a.m.**

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*The existing constellation of federal and state regulations is adequate to handle the fintech sector in consumer credit and payments. For all of the “tech” involved, fintech firms are still doing the same basic functions of transmitting payments and loaning funds as traditional financial services firms. To the extent that a problem exists, it is that some fintech firms, particularly in the credit space, would prefer not to comply with federal fair lending laws or state consumer protection laws. Nothing that these firms offer in the way of innovation, however, is worth eroding these important protections for the users of financial products.*

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*Fintech really does not present anything new in terms of regulatory challenges, excluding in the fair lending context. Most of the problems being raised, such as attempts to circumvent state usury laws through transaction, are not new. Professor Anne Fleming’s book City of Debtors (Harvard University Press, 2018) shows that financial services firms have been trying to do this in the small dollar lending space for over a century.*

*In terms of fair lending, fintechs that use nontraditional data sources for underwriting raise fair lending concerns because of the possibility of disparate impacts that disfavor protected classes. Unlike depositories, fintechs are not subject to examination for fair lending compliance, and their underwriting*

*formulas are a black box to consumers. Therefore, it is extremely difficult to detect fair lending violations in the fintech space.*

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*No. The NAIC has historically been more successful as a regulatory coordination mechanism than the Conference of State Banking Supervisors, but much of that has been because of the implicit threat of federal regulatory intervention if the states do not successfully regulate insurance markets. In the case of credit and payment markets, there is already a federal regulatory alternative—nothing stops a fintech from applying for a traditional banking charter—and the states have not historically proved particularly adept at coordinating their regulation. There is little reason to believe that they will step up their game now, not least because there are no obstacles to their doing so.*

*Ultimately, it makes sense to regulate fintech at the national level. We live in a national credit and payments marketplace. For example, creating a national money transmitter license would be a reasonable move to avoid uncoordinated state regulations. The catch here is that some fintech firms want federal regulation as a way of evading state consumer protection laws. Federal regulation makes sense if and only if it is accompanied by equivalent federal consumer protection regulations.*

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some of the challenges associated with state regulation, such as inconsistent and overly complex state usury standards (often riddled with loopholes for opaque or even abusive financial products), as well as lack of clarity around licensing for fintech firms that provide services to supervised state or national banks are unlikely to be addressed by states in the near term, and therefore will benefit from a significant degree of federal input and oversight.

What is the number one challenge of the rapidly growing fintech sector that cannot be addressed by the existing constellation of federal and state regulations or related laws?

- The top issue that cannot be addressed by existing federal and state laws or current regulations is the need to enable nonbanks to develop a national lending platform.

Does the growth of the fintech sector present new and pressing regulatory challenges, or are the regulatory solutions and needs being presented issues that are being raised from other problems already on our radar screen?

- To some extent these are variations of existing challenges, but to address these challenges from a fintech perspective, there is a strong need for an enlightened regulator who will work with the industry to come up with the best solution for enabling consumer access to credit, and who will be willing to provide interpretations of, and changes to, existing rules to better enable this access.

We're aware that our national financial system sometimes shines a light on differences in the way states regulate activity and differences between states and the federal government. In the insurance sector, many experts point to the National Association of Insurance Commissioners as having provided an excellent service of coordinating insurance regulation. Federal regulation of insurance is very sparse. Should we try to encourage better coordination among the states to cut back on some of the federal intervention in financial markets?

- There clearly is a role for states. The Conference of Bank Supervisors (CSBS) through its Vision 20/20 initiative has started a dialogue aimed at mitigating the differences in state law. Due to the variations across all 50 states, coordination at this level will have its challenges, but state regulators have always played, and will continue to play, a key role in oversight of the industry.

